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Travis J. Nelson

The Currency of Crisis: Empathy and Identity in Political Economy

Travis J. Nelson

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Reading Committee:
Jonathan Mercer, Chair
Caitlin Ainsley
Mark A. Smith

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Abstract

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Chair of the Supervisory Committee:
Jonathan Mercer
Political Science

While economists have increasingly acknowledged behavioral theories of preference formation, political economists have been more apprehensive about bringing in social psychology. Specifically looking at the global financial crisis and the ensuing sovereign debt crisis, I put forth a behavioral theory of preference formation in political economy. Empathy and identity play a critical role in shaping how individuals form groups, how crises are framed in public discourse, and how the issue framing affects policy outcomes. I use newspaper text and machine learning to demonstrate the prevalence of competing crisis frames based upon creditor, debtor, and outsider frames. I then look at government reports and provide a qualitative analysis of the reforms enacted as a response to the economic crises in the European Union. I argue that policy preferences, post-crisis, stem not from calculations concerning one's own pocketbook, or from purely pro-social calculations regarding the country's economic position; rather, preferences form in a manner consistent with more hedonic, experiential, calculations stemming from empathy for one's own perceived community and identity group that are molded by prior held beliefs, biases, and race.

Table of Contents

LIST OF TABLES	III
LIST OF FIGURES	III
LIST OF ABBREVIATIONS	IV
ACKNOWLEDGMENTS	VI
DEDICATION	VIII
CHAPTER 1: INTRODUCTION	1
THE CRISIS.....	4
THE THEORY: EMPATHY AND IDENTITY IN POLITICAL ECONOMY.....	9
HOW WILL I TEST THE THEORY?.....	11
CHAPTER 2: EMPATHY AND IDENTITY IN POLITICAL ECONOMY	15
EMPATHY AND POLICY PREFERENCES IN POLITICAL ECONOMY.....	19
PRO-SOCIAL VERSUS PRO-SELF ACTORS.....	20
EMOTIONS AND EMPATHY IN POLITICAL ECONOMY: FROM SMITH TO HIRSCHMAN.....	22
EMPATHY, BELIEFS, AND ECONOMIC POLICY PREFERENCES.....	24
SOCIAL IDENTITY THEORY.....	26
ATTRIBUTION THEORY.....	27
CONCLUSION.....	30
CHAPTER 3: TRADE WINDS OF CHANGE: ATTITUDES ON FREE TRADE IN EUROPE	33
LIBERAL INTERGOVERNMENTALISM VERSUS NEO-FUNCTIONALISM ON FREE TRADE.....	34
<i>Liberal Intergovernmentalism:</i>	35
<i>Neo-Functionalism:</i>	35
BEHAVIORAL APPROACH.....	37
THE DATA.....	38
CHANGES IN FREE TRADE PREFERENCES.....	39
CONCLUSION.....	48
CHAPTER 4: STATES, CRISES, AND FRAMES	50
THE CRISIS AND CRISIS FRAMING.....	51
BELIEFS AND INTERESTS.....	54
SOCIAL IDENTITY, FRAMES, AND ATTRIBUTION THEORY.....	59
DATA AND METHODOLOGY.....	63
RESULTS.....	66
CONCLUSION.....	72
CHAPTER 5: (DIS)EMBEDDEDNESS AND CRISIS IN THE EUROPEAN MONETARY UNION	75
COMPETING THEORIES.....	78
<i>Neo-Functionalism</i>	78

<i>Liberal Intergovernmentalism</i>	80
<i>A Behavioral Approach</i>	83
THE CRISIS AND CRISIS RESPONSE.....	85
<i>New Financial Regulators</i>	86
<i>Basel III and New EU Financial Requirements</i>	87
<i>Austerity and the EU's Contrasting Approach for Member States</i>	90
PROBLEMS IN THE EUROZONE AND NEW FORMS OF SUPERVISION.....	91
HIGH DEBT, PUBLIC OR PRIVATE? CUT BUDGETARY SPENDING!	93
THE SHORTFALLS OF NF AND LIG THEORIES	98
CONCLUSION.....	100
CHAPTER 6: CONCLUSION	103
BIBLIOGRAPHY	107

List of Tables

TABLE 1: THEORIES AND EXPECTATIONS	11
TABLE 2: TEST RESULTS FROM TRAINING RANDOM FOREST ALGORITHM	67
TABLE 3: CLASSIFICATION RESULTS BY COUNTRY/NEWSPAPER	68

List of Figures

FIGURE 1: CHANGE IN OPENNESS FOR FREE TRADE (2007-2009)	39
FIGURE 2: CHANGE IN OPENNESS FOR FREE TRADE (2007-2009)	40
FIGURE 3: CHANGE IN REGIONAL OPENNESS FOR FREE TRADE (2005-2019)	41
FIGURE 4: AGGREGATE CHANGE IN OPENNESS FOR FREE TRADE IN EU AND UK (2005-2019)	43
FIGURE 5: HEATMAP PLOT OF CHANGING TRADE PREFERENCES IN EUROPE (2005- 2019)	44
FIGURE 6: CHANGE IN OPENNESS FOR FREE TRADE IN GERMANY, FRANCE, THE UK, AND GREECE (2005-2019)	45
FIGURE 7: DEBT TO GDP RATIOS FOR GIIPS COUNTRIES	71

List of Abbreviations

- ARM – Adjustable-Rate Mortgage
- API – Application Program Interface
- AT – Attribution Theory
- BBC – British Broadcasting Corporation
- CDO – Collateralized Debt Obligation
- ECB – European Central Bank
- EBA – European Banking Authority
- EIOPA – European Insurance and Occupational Pensions Authority
- ESF – European Supervisory Framework
- ESFS – European System of Financial Supervision
- ESM – European Stability Mechanism
- ESMA – European Securities and Markets Authority
- ESRB – European Systemic Risk Board
- EMU – Economic and Monetary Union
- EU – European Union
- FDI – Foreign Direct Investment
- FDIC – Federal Deposit Insurance Corporation
- GDP – Gross Domestic Product
- GIIPS – Greece, Ireland, Italy, Portugal, Spain
- IMF – International Monetary Fund
- LCR – Liquidity Coverage Ratio
- LIBOR – London Interbank Offered Rates

LIG – Liberal Intergovernmentalism

NF – Neo-Functionalism

OCA – Optimal Currency Area

OMT – Outright Monetary Transactions

PMI – Primary Mortgage Insurance

RQMV – Reverse Qualified Majority Vote

SGP – Stability and Growth Pact

SIT – Social Identity Theory

UK – United Kingdom

US – United States

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This project has been a long time coming. I first gained interest in this topic when I was an undergraduate student studying abroad in Italy. I was an accounting major at the time, but politics quickly caught my attention as the financial crisis hit its depth while I was there, and the effects of the austerity measures were clear. Three of my undergraduate professors in particular played a large role in guiding me to where I am today: Barbara Mossberg, David Anderson, and Luciano Bardi. They steered me to study at Warwick University where I had the great opportunity to connect with other fantastic graduate students including Aaron Bowater and Manuel Scholz who remain great friends to this day. Warwick professors Simon Glaze and Andre Broom further guided me and asked me the tough questions that allowed me to further develop my own theories and research interests.

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Dedication

To my parents, John and Jodi Nelson, and my sister, Hailey Nelson. Thank you for all of your love and support!

Chapter 1: Introduction

*One ought to hold on to one's heart;
for if one lets it go, one soon loses control of the head too*
- Friedrich Nietzsche

December 14th, 2006 was a great day for Bear Stearns. Bear Stearns posted a 38% increase in quarterly earnings, coming in at a record \$562.8 million. Lehman Brothers, founded in 1850, reported a similarly impressive 22% increase in quarterly earnings at \$1 billion. Investors were so pleased with these record earnings that they awarded large bonuses to those at the top of the banks. The Bear Stearns CEO, James Cayne, was awarded 89,758 shares valued at \$165.32 a piece for a total value of \$14.8 million. Bear Stearns stocks dropped to \$2 per share a mere 15 months later as the 83-year-old firm was acquired by JPMorgan Chase. Just six months later Lehman Brothers declared bankruptcy after 158 years of business.

The collapse of Lehman Brothers and the acquisition of Bear Stearns served as pivotal points at the onset of the global financial crisis. What began as a subprime mortgage crisis evolved into a global recession marked by high levels of unemployment, a collapse in lending, the bursting of housing bubbles, widespread bankruptcies (consumer and corporate), ballooning debts (national and private), bailouts (including banks, automotive giants, and sovereign governments), and austerity. Most people did not spend much time thinking about welfare policies, banker salaries, or trade deficits prior to what was termed the Great Recession, yet they were thrown into a sea of these questions once the levees broke. This transformation in the saliency of economic and social policy leads us to ask questions about how individuals form preferences, how they interpret new

data, how prior held beliefs and biases shape the interpretation of new data, how group membership affects such data assimilation, and lastly, how this affects public policy.

Across the four main chapters of this dissertation, I focus on two questions. This first question is: how do preferences form in times of crisis? I then focus on: how do these preferences affect policy outcomes? I answer this question by first providing a behavioral theory of preference formation in political economy. I draw from behavioral economics, international relations and security, psychology, and sociology, bringing their rich literature into political economy. These fields have long understood the importance of behavior in understanding human nature and human interaction. Rational choice and purely constructivist theories of political economy offer us useful though incomplete tools for understanding crises in general, and crisis response in particular. This dissertation focuses on the European Union's response to the global financial crisis that began in 2007 as well as its response to the ensuing sovereign debt crisis. Understanding the role of empathy and identity in group formation, and attribution theory in understanding framing, allows us to take a step forward in developing a more systematic theory on preference formation in political economy.

The dominant theories used to explain preference formation within the European Union (EU), Liberal Intergovernmentalism (LIG) and Neo-Functionalism (NF), offer compelling yet incomplete explanations for the policies employed by the EU in the wake of the crisis. The financial crisis brought ruin to the financial markets which caused unemployment to swell, foreclosures to skyrocket, and national debt to balloon. When the sovereign debt crisis necessitated government bailouts, the EU worked to undermine the social structures and safety nets designed

to protect the most vulnerable members of society. The EU, European Central Bank (ECB), and the International Monetary Fund (IMF) forced austerity measures as a precondition of receiving bailout funds. LIG's focus on the role of national preferences in the EU decision-making process is a powerful explanation in this case; Germany's preferences resulted in a predictable outcome: austerity. LIG fails to explain the EU's decision to create Eurobonds, and the ECB's Outright Monetary Transactions (OMT is the ECB's policy of spending unlimited amounts of money to buy the bonds of troubled member states). In fact, Germany sued the ECB in an effort to prevent OMT but failed in court. NF struggles to explain austerity in this case, it would instead predict a further deepening of the EU's Economic and Monetary Union (EMU) through the creation of fiscal transfers to support social safety nets. When looking at the financial crisis, the EU responded by strengthening financial market regulations, increasing capital liquidity requirements for banks, and by placing a cap on banker bonuses. LIG and NF both would expect further coordination on financial market supervision, though not necessarily more normative policy on banker bonuses.

The behavioral approach offered by this dissertation provides the strongest explanation for the divergent policy responses of the EU to the sovereign debt and financial crises. The financial crisis was framed at the European level, it was the people of Europe versus the greedy bankers. The common European identity was dominant, and this framing allowed for a common European response. The sovereign debt crisis was more localized. National concerns, and empathy for your community led to a national identity becoming dominant, and the framing of the crisis in terms of more national and local interests. National stereotypes became dominant and can be broken down into whether the countries were debtor, creditor, or non-Eurozone/outsider in nature. The use of

Social Identity Theory (SIT) and Attribution Theory (AT) within the behavioral approach provide the most compelling explanation.

The rest of this introductory chapter will provide a general background and timeline on the global financial crisis. This background and timeline will serve as a useful tool in understanding the context of the dissertation project and its motivations. From there I provide a brief introduction to the theories employed in this dissertation, SIT and AT. This section on theory will provide a basis for the connection between emotion, identity, and policy preferences. The following section examines the cases used to test the theory.

The Crisis

The 2007-2009 financial crisis was a dire period that saw the collapse of the US housing market and the ensuing contagion that fueled a global recession. The US economy was running strong thanks to strong consumer demand and low interest rates that allowed for cheap borrowing. There was particularly strong demand in the housing market. The cost of a 30-year fixed-rate mortgage dropped from a high of 17.6% in February 1982 to 6.22% in January 2007. The decades of increasingly cheap money brought with it increased demand and allowed for a generation of Americans to purchase homes. The increased demand brought with it soaring home values, averaging 11% a year leading up to 2007. Banks responded by creating new products that would allow even more people to become homeowners. One such product was the Adjustable-Rate Mortgage (ARM). ARMs were created as a means to allow people to borrow money for a home with little to no down payment. Individuals with ARMs were able to obtain a mortgage with little down and would then pay an extra monthly fee as PMI (primary mortgage insurance). The loan

came with a fixed interest rate for a set period of time. Once the fixed period ended the monthly payments would become tied to the prevailing interest rate on a floating basis. Interest rates had been declining so there was little worry among borrowers that their rates would go up. Since house values were increasing at such a great rate, many were able to refinance their mortgage at a lower rate and no longer pay the added monthly PMI as the increased liquidity in the home would then meet the 20% threshold. Families were buying bigger and bigger homes and banks were collecting more and more fees on new mortgages and refinanced mortgages. Banks were able to take the mortgages they provided and sell them as CDOs (collateralized debt obligations) to investors.

CDOs were then broken down into different “tranches,” or pools, based upon their predicted levels of risk. Independent organizations such as Moodys would look at the collection of individual mortgages that would make up each security and then give it a rating. Those investing in shares of the riskiest tranche would receive the highest premiums but also be the first ones to lose money and bear the brunt of the pain should homeowners begin to default. Those investing in the safest tranche, the AAA tranche, would receive less in premiums but they would also be the last to feel the pain of defaults. A top rating of AAA did not, however, mean that the tranche was full of prime loans. Rather, it meant that the AAA tranche was “diversified” to the extent that the prime loans should balance against the subprime loans should there be an increase in subprime defaults.

By this point, individuals in the US were highly leveraged and vulnerable. From 2002 to 2007 there was a staggering increase in the debt held by individuals, going from 3.75:1 to 4.75:1. Acharya and Richardson (2009) point out that it had taken 15 years to see such increases in debt.

It was not just individuals who were overleveraged, the banks were also overleveraged. The US created the Federal Deposit Insurance Corporation (FDIC) following the run-on banks during the great depression. With the FDIC came protections for depositors, the insurance meant that people would no longer fear that their savings would disappear should their bank collapse. The insurance and increased level of trust in the safety of individual deposits allowed banks to pay less money in interest over time, it meant that depositors scrutinized liquidity ratios less over time, and that banks were in a better position to increase their leverage in investments. The amount of deposits in banks was eventually dwarfed by the amount of money lent by banks thanks to the lack of scrutiny and the securitization of loans. Banks that had traditionally be seen as intermediaries between depositors and borrowers (Diamond, 1984) had transformed into an entirely new entity.

On May 17th 2007 Ben Bernanke, then Chairman of the Federal Reserve, came out to try and quell the market fears that something was amiss in the housing market and that the growing level of mortgage defaults would not seriously affect the US economy. By June of 2007 Bear-Stearns' hedge funds began dumping their subprime mortgage holdings and it became apparent that other major institutions including Citibank, JPMorgan, and Goldman Sachs were in trouble as they had leant to the overly leveraged banks. July 2007 marked the beginning of the end for Bear Stearns. Bear Stearns announced that investors would receive little to no money from two of its mutual funds; the following month BNP Paribas announced a freeze on withdrawals from two of its funds as it was no longer able to value their assets due to a “complete evaporation of liquidity in the market.”

At this point, July 2007, the ECB the US Federal Reserve, the Bank of Canada, and the Bank of Japan all stepped in to try and increase market liquidity. The ECB alone pumped nearly €200bn into the economy over a one-week period. Central banks began cutting the interest rates set for lending to banks while London Interbank Offered Rates (LIBOR), which accounts for bank-to-bank lending, increased to their highest levels since 1998. When the British Broadcasting Channel (BBC) announced in September 2007 that the British bank Northern Rock had applied for, and received, emergency financial support from the Bank of England it triggered a bank run. Depositors withdrew £1bn in holdings, marking the first bank run in the United Kingdom (UK) since 1866. A US bank run on Washington Mutual followed a year later. Shiller (2017) looks at this period and brings in the idea of “narrative economics,” arguing that the collapse of the housing market, the run-on banks, and the increasing unemployment levels brought comparisons to the Great Depression. The Great Depression analogy led to the terming of the period that followed as the Great Recession.

As banks began to fail, central banks and national governments stepped in to fix them. Countries within the Eurozone were bound by a common currency, a common central bank, and the rules set in the Treaty of Maastricht that govern the group. The common currency meant that the exchange rates for countries in Europe’s periphery, such as Italy or Greece, were tied to the wealthier states in Europe’s core, such as Germany and Belgium. Countries typically have floating exchange rates based on the demand for their currency. Their central banks have a set of tools at their disposal that can be used to help affect their exchange rates, such as increasing or decreasing the monetary supply. States lose that level of control over exchange rates when in a currency union. Italy and Greece, then, were tied to Germany and Belgium on exchange rates, while in the past

they would have the option of devaluing their currency to make their domestic economies more competitive. The lack of strong national central banks in the currency union also limited the ability to bailout the government through the banks' printing of money and through the purchasing of bonds, as well as their ability to bailout domestic industry.

As banks throughout the EU needed bailouts, their home states were forced to take on bailouts as the intermediary. Ireland and Spain were among the member states that went into the crisis with strong economies, budgetary surpluses, and low public debt but were forced to take on debt to bailout their private sectors. They were unable to borrow from bond markets as interest rates had risen to a prohibitive rate as potential buyers evaporated. As countries accepted bailouts from the Troika (the European Commission, the European Central Bank, and the International Monetary Fund), they were forced to implement austerity measures as part of the terms.

The EU pushed for austerity within the member states receiving bailouts, and it worked to create new regulations for banks and investment firms to prevent future crises. Though the sovereign debt crisis was the result of spillover from the global financial crisis, a one-size-fits-all approach was utilized in the crisis response. Regardless of why the individual bailouts were needed, a common narrative and framing of the crisis persisted: that the countries receiving bailouts were the makers of their own problems, that they were profligate spenders with overly generous welfare programs. While that may have been the case in Greece, the Greek case is not reflective of the other medium to large states that received bailouts (Italy, Ireland, Portugal, Spain). Greece was the exception, not the rule.

The Theory: Empathy and Identity in Political Economy

Understanding empathy and identity allows us to better understand how preferences form and how we view the actions of others. In “The Theory of Moral Sentiments,” Adam Smith argues that individuals care about more than just their narrow self-interest, they care also for the interest of those around them. Smith argues that each person has an “impartial spectator” within them and that they use this spectator to view their own actions and the actions of others. The spectator within us helps us to view the actions of others and to “sympathize” with others. While Smith refers to it as sympathy, he is really referring to the concept of empathy which had not yet been invented as a term. Empathy is the act of putting yourself in the shoes of another person, relieving yourself of any biases, and imagining the position of others. Smith sees this sympathy, or empathy, for others as being in competition with a person’s narrower self-interest and that this sympathy for others is typically more limited to members of one’s community. I do not argue that empathy for others is in direct competition with more traditional interest based rational choice arguments. Instead, I argue that understanding emotions such as empathy provide a critical component to understanding how preferences form.

Emotions cannot be separated from rational decision-making (Damasio, 1994); indeed, rational decision-making relies on an emotional understanding of events. This logic can be applied to explain both preference consistencies over time, as well as sudden changes in preferences. Changes in how actors frame the situation affect their beliefs as to how the situation needs to be addressed (Farnham, 1992). Indeed, the way events are experienced affects the framing of future

decision-making. Decision-makers will be affected by prior experience when forming their preferences moving forward regardless of whether the intended result is achieved.

Chapter 2 focuses on developing a behavioral theory of preference formation in political economy and draws from SIT and AT. SIT focuses on group formation. Individuals have multiple identities. These identities come from all different levels, they can be based on one's gender, nationality, sports affiliation, or even their job. The more salient the identity the more likely it will be triggered during a crisis. As these identities take hold, individuals take on a collective identity with their group. The more one feels for their group, the more they are likely to have negative views of others, the out-groups.

AT can be used in conjunction with SIT in developing a behavioral theory on preferences. While SIT tells us how groups form, AT tells us how individuals, and in our case groups of individuals, will view the actions of others. The actions of members of one's in-group will be seen in situational terms when it is seen as something negative, and in dispositional terms when it is seen as something good. That is, our friends had no choice but to do what they did when it was not something positive though when they do something great it is because they are a great person. The opposite is true for members of the out-groups. If members of the out-group does something good, it will be explained by the situation, and if they do something bad it will be explained by their disposition. Members of the out-group will rarely, if ever, be seen in a positive light.

How Will I Test the Theory?

Chapter 3 focuses on how preferences changed before and after the crisis using data from the Eurobarometer surveys ranging from 2005 to 2019. I focus on the survey questions looking at free trade preferences and how they have fluctuated over time. These questions help me to examine the relationship between empathy for one's in-group and their economic policy preferences. As the economic position of individuals decreases, their anti-trade sentiment increases. Kinder (2004) furthers the sociotropic argument surrounding individual attitudes as being based on experiences during crises. Anti-trade sentiment is expected to increase as the crisis hits. Table 1 provides an overview of the hypotheses derived from the behavioral approach used in this dissertation, compared to the hypotheses derived from the two competing theories, LIG and NF.

	Hypotheses		
	Trade	Welfare	Banking Reform
Behavioral Approach	National and subnational preferences, protect members of the in-group	National framing; creditor, debtor, outsider lines shape understanding of crisis	European level framing, "us Europeans" versus "greedy bankers" and deeper regulation at EU level
Liberal-Intergovernmentalism	National level preferences, focused on best interest of member state	National framing; national politics and German and creditor interests prevail	National level bargaining, deeper regulation at EU level
Neo-Functionalism	European level preferences, focused on further supranational integration to mitigate future crises	European/Supranational framing and deeper integration at EU level; Eurobonds and fiscal transfers	European level bargaining, deeper regulations at EU level
Outcomes	General movement against trade, near across board reduction in openness to trade.	Cuts in welfare through forced austerity measures, but also Eurobonds and OMT despite German lawsuit	Deeper regulations for financial markets through new EU institutions, including normative restrictions on bankers' bonuses

Table 1: Theories and Expectations

Chapter 4 focuses on the interconnection between SIT and AT, and how these theories work together in explaining the framing of crises. SIT allows us to use AT at the group level. While AT focuses on how individuals explain the actions of other, SIT and AT working together and allows us to better understand how groups explain the actions of other groups. The use of framing here connects the ways in which groups discursively construct the actions of others. The negative actions of a member(s) in the out-group will be framed in dispositional terms. The negative actions of a member of one's in-group will be framed and understood in situational terms. Framing is not simply a top-down phenomenon in which the elite drive public opinion, nor is it simply a bottom-up phenomenon in which the elite are strategically acting upon the cues of the masses. Mark Smith (2011: 35) argues "the common understanding of framing as a top-down, elite driven process should be replaced with a more complex view whereby the beliefs and experiences of citizens affect what will resonate with them." The political elite act in a way that capitalizes on the experiences of their citizens, the saliency of one belief set over another, and the currency of crisis.

Over time, political entrepreneurs link economic beliefs, such as those of Adam Smith, Milton Friedman, Karl Marx, or John Maynard Keynes to public policy. The political elite grasp at economic ideas that feel correct. As unemployment is seen as rising, protectionism often feels like the right response. People do not always lose their jobs due to a crisis, but as empathy is institutionalized in local social groups, people care about the welfare of their community. Thus, we see the waxing and waning of protectionism tied to both the empathy one feels for one's community as well as to the saliency of the anti-trade rhetoric through policy linkage. Chapter 4 focuses on providing a quantitative analysis of how the crisis was framed in the media in six countries: The United Kingdom, Norway, France, Germany, Spain, and Greece. By looking at

these six countries we see how the crisis was discursively constructed within outsider non-Eurozone members (UK and Norway), creditor states within the Eurozone (France and Germany), and debtor states within the Eurozone (Greece and Spain). Tracing the economic beliefs in each state, as well as showing the role of identity and emotion helps us to understand the discursive construction of the crisis, and attribution theory allows us to understand how they see the crisis in a comparative manner.

Chapter 5 focuses on the distinction between the European identity and the national identity in affecting actual policies enacted during the crisis. Building on the quantitative analysis of chapters 3 and 4, chapter 5 looks at how the framing of the sovereign debt crisis, as creditors versus debtors, and the profligate south versus the greedy north, as having a real effect on the policies enacted as a response to the crisis. A common solution of austerity was imposed on all southern states regardless of the underlying causes of the crisis. Spain entered the crisis with an annual budget surplus and low levels of government debt, about half the debt than what is allowed under the Stability and Growth Pact (SGP), while Greece entered the crisis with a large budget deficit and high levels of government debt, about twice the debt than what is allowed under the SGP. Spain was treated the same as Greece when it was forced to take on loans to fund the bailout its banking industry. The EU worked to dis-embed social welfare markets from society in the south through austerity measures that are still felt today. While the EU was pushing austerity and dismantling welfare regimes, it was also working to further embed financial markets into society with the creation of a range of different regulatory bodies. The European identity was supreme, it was the European community against the banks. A very different narrative than the one introduced

to discuss the sovereign debt crisis, though it was largely the banks that played a key role in creating the sovereign debt crisis.

Chapter 2: Empathy and Identity in Political Economy

*A banker is a fellow who lends you his umbrella when the sun is shining,
but wants it back the minute it begins to rain*
- Mark Twain

Financial crises are unfortunately a recurring feature in society. Financial crises have become more pronounced as societies across the globe have become increasingly interconnected. Banks no longer predominately lend just to those they know in their local communities; they have grown into large entities that lend globally. The Peruzzi and Bardi families were two of the most prominent banking families in Europe during the 14th century. Both families were based in the city of Florence, modern Italy. The Peruzzi and Bardi families made the unfortunate decision of loaning money to King Edward III of England to help fund his war against France. When King Edward III defaulted on his loans, the banks were able to survive for some time, but were never again the power houses they once were. They eventually collapsed. The English monarch's default may have hurt the Peruzzi and the Bardi families, and it hurt their ability to lend money to others, though the default did not bring the global economy to its knees. The citizens of Florence and London went on with their lives. Large scale sovereign defaults today are rare. Sovereign defaults may be rare, though the fear of a default can be devastating. Modern creditors are diffuse and discerning, unlike in the days of King Edward III where monarchs ruled near absolutely and could acquire favorable loans on demand. Modern creditors can make or destroy economies through their lending or their lack of lending. Fear of contagion alone can be enough to cause significant damage to a bank, the entire banking sector, and even the finances of sovereign states. This leads us to consider how individuals, and how groups of individuals, form beliefs about the economy and about society in general.

How do individuals come to form opinions about the world around them? How do some come to follow one world view while others come to hold completely opposing views? Much research has been done in the fields of economics, psychology, international security, and American politics on the role of beliefs, heuristics, and biases in shaping individual preference formation (Farnham, 2000; Kahneman and Tversky, 1979, 2000; McDermott, 1998; Mercer, 2010, 2014; Schiller, 2017; Thaler, 1980, 2016) though little has been done in the world of political economy. The field of political economy has been reluctant to embrace some of the path breaking work done by its contemporaries. The study of beliefs, identity, and emotion should be at the forefront of research in political economy. The last few years have witnessed a drastic change in the sphere of politics. Parties once on the fringe have become power players. The far right in Germany grew to lead the opposition (Alternative für Deutschland), the UK left the EU, ardent anti-EU populist Marine Le Pen was nearly elected as president of France, Donald Trump was elected to be president of the United States (US) in 2016.

The rise in populism and the pushback against “politics as usual” in the US and EU can best be explained through understanding how individuals form in-groups and out-groups along the lines of their identity. Oxford dictionary defines identity as “the characteristics determining who or what a person or thing is.” Someone can identify as a male or a female, as a hiker or a surfer, or as a Dane or a European. People hold multiple identities. One can identify as a white male conservative from Poland, establishing their racial, gender, political, and national identities. While people may hold multiple identities, they do not necessarily need to work in the same direction (Klandermans, 2013). Identities, while sometimes complementary, can also come into conflict. The person may identify as Polish, European, male, conservative, and as a banker. Depending on

the identity, the groups formed can be large or small, inclusive or exclusive, cross-cutting, or even nested. Members of the University of Washington college football team would have a small, inclusive, collective identity given the barriers to entry and the limited size of the team. A football player from California could further have a collective identity shared with the larger, more inclusive, group of “Californians.” The Californian identity could be further nested in that football player’s even larger shared collective identity as an American. The identity triggered when discussing policy shapes how one views the issue, allowing the formation of their in-group and the formation of the out-group.

Identity salience can be seen as hierarchical (Morris, 2013). Identities are triggered along the lines of the “salience hierarchy.” The more committed one is to a specific identity, the higher its position in the hierarchy. This means that when one holds a strong national identity, their national identity is more likely to be triggered when issues are framed as affecting the nation as whole. Different events trigger different identities and thus their policy preferences moving forward. I am interested in the policy preferences of the individual and understanding how these preferences percolate up to the national and supranational levels.

Empathy is a powerful emotion that drives how individuals view others, how they form groups, and helps explain how they come to form opinions on policy (Sirin, Valentina, and Villalobos, 2016). Empathy can be hard. Abandoning any biases and putting yourself in the position of another person is a difficult task. Empathizing with one’s neighbor, one’s family member, or some other member of one’s own community is not always a very difficult task. People may even empathize with others without even recognizing that they are doing so. Empathy for members of the out-group can be difficult or even impossible (Simas, Clifford, Kirkland, 2020).

This chapter will first delve into the relationship between the emotion of empathy and policy preferences in political economy. Most of the literature in political economy focuses purely on the role of economic self-interest in preference formation and leaves out the roles of identity and emotion. Emotion plays a critical role in the transformation of economic beliefs over time and thus policy preferences. Emotions such as empathy are rational. Mercer (2013, 227) points out how “one cannot have preferences, let alone stable and hierarchical ones, without emotion.” In discussing identity, I will pay particular attention to the fluid way different identities take form, and the role of mental schema and framing effects in shaping identities – often along racial lines.

After the discussion on empathy and identity in political economy, I focus on the three cases to be discussed in the following chapters. The first case, chapter 3, focuses on changes in preferences to free trade. Chapter 4 relies on AT, an individual level theory that explains how individuals explain the actions of others through situation or disposition depending upon their group membership. Here I used a text analysis of newspaper articles from France, Greece, Germany, Norway, Spain, and the UK in demonstrating the competing logics of the crisis, and how these logics stem from nationalist identities and experiences. Chapter 5 then shows how nationalist identities took hold during the sovereign debt crisis in Europe, and how those identities shaped popular discourse and framing surrounding the crisis. Chapter 5 builds on chapter 4’s text analysis and demonstrates how the competing logics used to explain the foundations of the crisis shaped the EU’s response to the crisis. I focus specifically on the differences between how the EU responded to the sovereign debt crisis and how it responded to the banking crisis, focusing on the institutional design of the EMU, as well as on the role of economic ideology and beliefs in shaping the design of new regulatory institutions. While the EU faced some constraints in its response due

to the Maastricht Treaty and the regulatory institutions it created, the EU had the opportunity to create a new regulatory regime to help prevent future crises. The new regime served to further entrench the economic ideology of the more powerful northern creditor states, embedding financial markets in deeper government regulation, and dis-embedding state welfare markets through forced austerity most felt by debtor states in the south.

Empathy and Policy Preferences in Political Economy

Much of the literature in political economy is focused on whether individual policy preferences are derived from material interests or other prosocial interests. For example, when we think about the political economy of trade, the thrust of the debate comes from the Stolper-Samuelson (Stolper and Samuelson, 1941; Helpman and Rogoff, 2004; Dhingra, Machin, and Overman, 2017) and the Ricardo-Viner (Krugman, 1993; Gros and Thygesen, 1998; Pisani Ferry, 2014) models. These models look at relative factor endowments and their effects on preferences for trade openness. Scholars using these models look at the factors of labor (skilled and unskilled), and at industry-based factors. Wealthy, industrialized, states such as the United States, Canada, and Switzerland, are those in which there are high levels of human capital and economic capital. The expectation in such cases is that those involved in these high skill industries will push for trade openness with countries where these skills are under abundant. The same is true for those within countries where there is an abundance of low-skill labor, where members of that workforce will push for trade openness with countries where there is an abundance of capital but an under abundance of low skill labor. The theorem follows that capital will flow in the form of investment from the abundant to the under-abundant state, while goods will flow from the capital under-abundant state to the abundant state. This results in an equilibrium in which both sides are made

better off. The basis of such arguments is the self-interest of individuals. As Downs (1957: 42) points out, “rational men are not interested in politics *per se* but in their own utility incomes. If their present utility incomes are very low in their own eyes, they may believe that almost any change to be made will likely raise their incomes.” This is what is referred to as “pocketbook” voting. Individuals notice the relative changes in the cost of goods at the grocery store, they notice wage stagnation, and they tend to blame the incumbent government regardless of their underlying fault. Popkin’s (1991) influential book follows this line of logic that individuals do not gather additional data to inform their vote preferences but instead base their preferences purely upon their own economic planning. They want to maximize their own economic utility and not, necessarily, the utility of those surrounding them.

Pro-Social Versus Pro-Self Actors

Pocketbook voting remains a powerful notion in popular discourse as people attribute the loss of jobs at home to trade abroad. Mansfield et al. (2014) note that in a 2009 survey of the American public, Americans attributed the cause of the 2007-2009 financial crisis to the banking industry and loose regulations, to the federal government, and to individuals who took out loans they could not afford. The significance of their point is that while people did not associate trade with the underlying causes of the financial crisis, the wisdom of openness to trade since the crisis has been questioned by many. If we do not think that individuals are mere pocketbook voters, what else can help explain their preferences? Rho and Tomz (2017) argue that as economic literacy increases, people tend to form preferences in line with their economic interest. Their argument is that there is currently a divergence between policy preferences regarding trade, and economic self-interest. As people become more aware of the distributional effects of trade policy, they act in a

way to maximize their position within the confines of the expected distributional outcomes. Thus, the divergence between self-interest and policy preference today is not due to a sociotropic, or other-regarding, mentality held by the public but due to a lack of knowledge that clouds more rational calculations.

Other arguments surrounding preferences for trade openness stem from a more sociotropic standpoint (Kiewiet, 1983; Kinder and Kiewiet, 1981). Individuals care for more than just their own narrow self-interest, but also the interest of their community or nation. People vote not by their personal pocketbook, but by the pocketbook of the nation. If they feel that they personally may benefit from free trade, but the country overall will be made worse off, then their preferences will update against free trade. There are several driving forces that play a role in explaining trade preferences in a non-materialist manner. Some (Mansfield and Mutz, 2009) argue that rising ethnocentrism helps explain support for protectionism, arguing that as support for American racial/ethnic in-groups increase, sentiments against out-groups then comes to work against trade with such groups. Such arguments leave out economic rationale, and more on a general tendency towards isolationism – that is, out-group hostility leads individuals to prefer little to no contact with others, be it trade, security cooperation, or foreign aid. Mutz and Kim (2017) further this argument by looking at the impact of in-group favoritism and out-group angst on trade preferences. Individuals are seen as privileging their own nation’s interest in trade policy out of feelings of national superiority through “compatriotism,” arguing that “people categorically favor one group of unknown strangers over another purely because of their membership in the group” (Ibid: 830).

Guiso et al. (2013) look at the role of risk aversion in times of crisis. While people may not attribute trade as the cause of the crisis, their heightened anxiety post crisis causes them to worry that they may be next. That is, as they see those around them losing jobs, they worry that continued trade openness may lead to the loss of their own job in the future. The reverse would be expected to be true in times of plenty, as they see people coming home with greater gains from trade, they would likely be more risk tolerant in accepting the trade-offs.

Emotions and Empathy in Political Economy: From Smith to Hirschman

The argument put forth in this dissertation is that individuals form policy preferences in line with the empathy they have for members of their in-group. In particular, I draw on Adam Smith's work on empathy in his book "The Theory of Moral Sentiments." While Smith is best known for his work in economics on the invisible hand of the free market, he was best known during his lifetime for his work on empathy and emotions. Smith argues that individuals are not merely driven by pure economic self-interest but are also driven by a sense of social responsibility. Hirschman (1977) makes a similar argument that looks at the development and rationale behind the capitalist system in understanding how society can temper some of its "passions", read emotions, to have a more equitable system. This is not to say that individuals are not self-interested or that people are purely altruistic; this is not the case. People tend to not only care about their own position in life, but also the position of their neighbors, family, and friends; those within their in-group. Preferences form based on how individuals believe they can maximize the interest of their in-group.

Empathy is a distinct emotion. It is different than sympathy. As the rock band the Rolling Stones once implied, one may have sympathy for the devil. Sympathy for the devil would imply the act of feeling pity or sorrow for another individual. One may argue that it is actually quite easy to have sympathy for the devil. While sympathy for the devil could be easy, it would be quite difficult to have empathy for the devil. It would be extraordinarily difficult for one to put themselves in the shoes of the devil and to take on the mindset of the devil to understand the devil's actions. Though one may feel sympathy for the devil through the act of feeling pitiful for the devil, or by feeling sorrowful for the devil after its being "cast down from heaven" as a means of understanding its situation. Feeling empathy for members of one's own community during a crisis is therefore distinct to feeling sympathy for them.

Fear is another distinct emotion. Fear is often seen as a driver of human action. One may fear the devastating results of a hurricane and choose to not live in an area that is prone to hurricanes. One may fear the impending scene in a film and choose to close their eyes. One may fear the loss of their job in a recession and act in a pro-self manner. Though this is not the argument of this chapter. While on the fringe this may be the case, the argument is that while the emotion of fear may indeed be present in times of economic turmoil, as would be sympathy, the driving emotion is that of empathy. Crawford (2014) looks at how empathy and emotions lead to an institutionalizing effect of fear and empathy. Fear, and its "antidote" empathy are institutionalized into social groups and organizations through experience. 9/11 struck a chord of fear and anger throughout the US which led to the institutionalization of fear in its intelligence agencies, and some of its other foreign and domestic policies. Empathy, too, can be seen as institutionalized in domestic structures in the US, and in other states largely in the form of social welfare assurances.

Though the driving emotion, and logic, behind policy preferences is that of empathy, and the empathy one has for members of their in-group. Empathy goes beyond the act of feeling sorrow or sympathy, it requires individuals imagining how they would feel in that same position. It is empathy more than sympathy that leads to the policy preference of trade protectionism as it comes out of a sense of duty to protect those within your in-group.

Empathy, Beliefs, and Economic Policy Preferences

Economic crises are times of extreme emotion at the individual level. People fear whether they will keep their job, their house, their lifestyle, and even their family. Those who are fortunate to not be personally affected by crises still feel the effects of crises. They see how those within their community are affected, they see the foreclosure signs going up, the local mom and pop stores closing, and see their friends and family being laid off in large scale by local firms and industry. Economic self-interest alone does not explain how individuals form policy preferences in times of economic crisis. People care not only about their own economic interest, but also the economic interest of the perceived community in which they live. They form preferences based on the interests of those around them. As Mercer (2013) argues, people use emotion as evidence, “feeling is believing.” Strong shocks, be they security or economic crises, often cause individuals to reassess their policy views and beliefs in a way that elicits radical change.

Emotions such as empathy feed into policy preferences and beliefs. Beliefs and ideologies change over time through experience and trial and error. Some economic policies work better in some states than in others for a variety of reasons; level of development, natural endowments, or domestic cleavages are a few potential reasons. While most people do not lose their jobs during

such downturns, they are aware of others who have. The empathy for those within their in-group plays a strong role in economic policy preference formation. Those who may still have their job in the factory worry that their children or neighbors will not be able to follow in their footsteps. They worry that their neighbor lost their job due to globalization, and they worry free trade and cheaper goods means a tremendous cost for the local working class. Whether or not these worries come to fruition is not important. What matters is that these worries, and the empathy felt for those in the in-group, work to promote more protectionist and closed policy preferences.

Anxiety due to the loss of one's own job, the potential loss of one's job, or the empathy felt for those who have lost their jobs is a driving factor in preferences for protectionism. While this empathy also exists for those on welfare following the crisis, it does not apply to all people on welfare. Fluid identities lead to different in-groups and out-groups when it comes to the policies of trade and welfare. Racial stereotypes for those on welfare lead to vastly different beliefs and policy preferences when it comes to welfare than it does trade.

This leads us to the question of what defines a community. What role do stereotypes play in forming notions of in-group versus out-group? Are communities malleable? Or are they event or policy specific? Ansolabehere et al. (2014) look beyond both micro- and macro-economic theories and look specifically at "macro-economics" which is somewhere in between the two. People look at those in similar positions to themselves rather than purely at the individual or at the national levels. "[The] theory of macroeconomic voting posits that voters use the noisy signals about aggregate economic performance they get in their daily life to make inferences about the state of the aggregate economy" (Ansolabehere et al., 2014: 380). Individuals collect data based

upon both their own daily experience and the observed experiences of those surrounding them to inform themselves of the general economy.

Social Identity Theory

SIT provides an understanding of group formation. This builds on my argument that individuals form policy preferences based on their empathy for others, but that the concept of “other” changes based on the situation. Different situations are likely to invoke different identities and thus shape who is seen as within the in-group, and who is in the out-group. For example, group formation can be along the lines of management versus workers, University of Washington Husky fans versus Washington State University Cougar fans, or even blonds versus brunettes. Group formation is natural when conflict occurs; such conflict can be over symbolic issues such as physical attributes, or over material issues such as the distribution of wealth or the proliferation of nuclear weapons. SIT posits that the more strongly people feel for their in-group, the more negatively they will feel for the out-group. Nationalism is a great example of this. The more strongly one identifies with their national identity, the more likely they are to have more negative views of other nationalities.

SIT allows us to understand how and why groups are formed, in addition to providing an understanding of how these groups can come to interact with one another. Competition is seen as an inherent component in society. Not only can there be multiple groups vying for “more,” there is also overlap in group construction. One can both identify as an American and of African descent. In such a case, one’s national identity maybe more salient when thinking about issues of trade or

nuclear proliferation, while one's racial identity may become more salient when thinking about issues such as voter ID laws or education funding. Allport (1954: 30) writes:

As early as the age of five, a child is capable of understanding that he is a member of various groups. He is capable, for example, of a sense of ethnic identification. Until he is nine or ten he will not be able to understand just what his membership signifies—how, for example, Jews differ from gentiles, or Quakers from Methodists, but he does not wait for this understanding before he develops fierce in-group loyalties.

In-group formation is a natural phenomenon. People are socialized into groups subconsciously from birth. The groups that individuals are socialized into may be social constructions, yet they can become powerful components of the person's identity. The empathy felt for others in the in-group allows for individuals to prefer policies that benefit their group over other groups.

Attribution Theory

AT builds on our understanding of preference formation by providing a basis for how individuals, or in our case groups of individuals, explain the actions others. These actions can be explained in either situational or dispositional terms depending on whether or not the person, or group of persons, is within the in-group. If a friend does something good, it is because they are a good person, but if an outsider does something good it is because anyone in that situation would do the same thing. The opposite works when something bad is done; the friend had no choice, and the outsider did it because it is in their nature. Attribution Theory looks at how individuals characterize and explain the actions of others. Mercer remarks (1996: 17):

A situational attribution has only within-situation validity; it cannot be used to predict or explain behavior in a different situation. In contrast, a dispositional attribution can have cross situational validity; it can be used to predict or explain behavior in a different situation.

In this way, AT works well with SIT if we see “in-group” as friendly, and “out-group” as outsider. Through SIT and AT we can always expect out-group behavior to be understood in negative terms – nothing an outsider does can ever be good. In the most generous of times, out-group behavior is seen as benign.

In this sense the concept of dispositional versus situational understandings of behavior follows what we see within the EU. Countries such as Ireland or France would be expected to have different qualities attributed to them in times of crisis than would those such as Greece or Spain. This understanding of dispositional versus situational explanations, based upon prior held beliefs and biases, leads to the discursive construction of the south's economic woes as stemming from their nature. It was their profligate governments who overspent and provided overly generous pensions and other social welfare benefits. Coming in contrast to the situational discussion concerning northern countries. They are seen as victims of circumstance; the global financial crisis caused their debt problems. We see this most blatantly in the UK's response to the bailouts. The UK chose to bailout its northern neighbor Ireland and refused to participate in the bailout of any other EU state. This happened even though countries like Spain had the same problems as Ireland; high private debt from a housing bubble and little public debt and UK banks had similar exposure in the two countries. Those in the UK had empathy for the Irish position as Ireland was treated as part of the in-group. It was the empathy felt for their Irish compatriots that led to the policy preference of providing a bailout.

When using situational and dispositional frames the expectation is that the public holds such views. When they “judge” the actions of others they are seen as judging state actors,

institutions, and the public. An example of this would be the German public, or a large subset of the public, looking at the Eurozone crisis as being the result of government profligacy in the south, the character of those living in the south as being lazy, and poor institutions (namely inept tax collectors). The key here is that the beliefs and frames held by the public is what is important.

This argument relies on the existence of a relationship between public opinion and policy outcomes. Druckman and Nelson (2003: 730) succinctly refer to framing effects as: “when in the course of describing an issue or event, a speaker's emphasis on a subset of potentially relevant considerations causes individuals to focus on these considerations when constructing their opinions.” That is, discussions around events can take many different forms. For instance, when discussing a food crisis in a different country, the crisis can be framed as one of a humanitarian crisis or as a security crisis depending on how the event itself is talked about. The different types of frames carry with them different responses. Thus, the relationship between public opinion and the elite is an important one. Druckman and Nelson (Ibid) point out that frames are developed in several different ways. A particularly important relationship is the interpersonal relationship. That is, a group of friends discussing current events has a profound effect on how an individual in such a group frames the crisis or event. The composition of groups is also important in understanding how one frames an event or crisis; this is particularly true for groups with members holding opposing views. Depending upon prior held beliefs, frames may converge within groups, or they may diverge. Elite framing can also play a large role in shaping public discourse. Individuals not only take cues from their friends and colleagues, but also from the television, newspapers, and politicians. In their book, “Listen, We Need to Talk: How to Change Attitudes about LGBT Rights” Harrison and Michelson (2017) make the argument that partisans rarely change their views on issues such as marriage equality. While some posit that exposure to different groups and beliefs

may shape beliefs over time, they argue that it takes influential members of the in-group changing their beliefs to get the rest to follow. In this way, people take queues from members of their in-group in forming their preferences. They draw on the example of former US President Barack Obama changing his view on gay marriage. Prior to his change in beliefs, members of the democratic party were largely against marriage equality, quickly changing and re-evaluating their views once the leader of their group provided the impetus for re-evaluation.

Conclusion

Empathy and identity play an undeniable role in shaping how individuals view the world around them. Our identities as individuals explain how we view ourselves. They also help to explain how we view others. Identity politics has come to explain much of the discord within society. Scholars have used it to explain the rise of Donald Trump in the US (Sides, Tesler, Vavreck, 2016; Papakyriakopoulos and Zuckerman, 2021), Brexit in the UK (Noury and Roland, 2020), and the “culture wars” that take place on social media (Bennett, 2012). While the role of identity in politics certainly helps explain the divisiveness we see in society, it also helps to explain the love and trust we have for others. Emotions play an important role in forming the relationships we have with ourselves and with others. Emotions are not illogical or irrational. Rational decision making requires some level of emotionality. Adam Smith’s work on what he called sympathy (the term empathy had not yet been created) focused on the compassion we have for others in our community. Of course, we care about how we ourselves are affected personally by a crisis; we also care about how those around us are affected. There are limits, however, on who we seek to defend or protect. We seek to protect those within our in-group, groups whose membership can be

as narrow as siblings when arguing with older relatives at holiday dinners, or as wide as that of humankind when banding together against an alien invasion.

Individuals hold many identities, and these identities fall into a saliency hierarchy. The more salient the identity, the more likely it will be triggered during a crisis. We then take on a group, or collective, identity that shapes how we view the actions of our in-group partisans and members of the out-group. AT tells us that when members of the out-group do things that are positive, such as providing foreign aid, it is explained in situational terms. All states with the capacity for providing foreign aid have done so. When members of the out-group do something negative, such as invade a neighbor, it is explained in dispositional terms. They are warlike and expansionary people. The opposite is true when members of our in-group do the same thing. Members of our in-group providing foreign aid are seen as kind and compassionate. Members of our in-group who invade others are seen as doing so because they had to for their safety or defense.

AT gives us a clear set of expectations for how states in Eurozone's core (Germany, France, The Netherlands as examples) to frame the financial and sovereign debt crises compared to how those outside of the Eurozone (The UK) or those in the Eurozone's periphery (Greece, Italy, Spain as examples) to frame the crisis. Countries in the core are likely to explain the problems faced by countries in the periphery in dispositional terms. Countries in the periphery are likely to explain their problems in situational terms. Those outside of the Eurozone are expected to explain the crisis as being the fault of the system. It was doomed to fail. The next chapter, chapter 3, looks at the fluctuating preferences for free trade across Europe, particularly looking at how the exogenous shock of the financial crisis affected these preferences. Chapter 4 digs into these hypotheses with

a quantitative text analysis of newspaper data. Chapter 5 then focuses on how the most powerful of these frames, those held by the creditor states in the Eurozone's core, came to be at the center of the EU's policy response to the crisis. A response that consisted of dis-embedding state welfare markets from society through austerity measures, and new regulations for the banking industry.

Chapter 3: Trade Winds of Change: Attitudes on Free Trade in Europe

How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though he derives nothing from it except the pleasure of seeing it.
- Adam Smith, *The Theory of Moral Sentiments*

The winds of economic change swept through the EU during the financial crisis, reshaping public opinion and policy preferences in areas such as free trade, national welfare policy, and financial market regulations. This chapter delves into understanding the changing attitudes towards free trade using Eurobarometer surveys between 2005 and 2019, a period marked by significant economic upheavals including the 2008 financial crisis and the subsequent European sovereign debt crisis.

At the heart of this chapter is the fundamental question: How did attitudes towards free trade evolve across Europe during this tumultuous period? To answer this question, this chapter presents a comprehensive descriptive analysis of trade sentiment trends, Eurobarometer data that captures the ebb and flow of public opinion across countries and time. The analysis aims to show the complex shifting of attitudes across Europe. The chapter examines overall trends in trade sentiment that reflect the economic turbulence of the period, with a particular focus on how the financial crisis influenced public opinion. By comparing patterns across different EU member states, the chapter illuminates the relationship between national economic experiences and attitudes towards free trade.

The purpose of this chapter is not to provide a causal argument or claim, but rather to set up the argument that preferences do indeed change during crises. We will explore how these changes manifest across different countries and time periods, setting the stage for a deeper analysis in chapters 4 and 5. While traditional theories such as LIG and NF offer valuable insights into the macro-level dynamics of EU integration and trade policy, this chapter argues that they may not fully capture or explain the nuanced shifts in public opinion we observe. The complex patterns of changing trade attitudes suggest that a more nuanced approach is needed to fully understand these shifts.

The behavioral approach offers a micro-level perspective that complements the macro-level theories. By incorporating insights from SIT, AT, and the role of Empathy, the chapter aims to develop a more comprehensive framework for understanding how individual-level factors, social identities, and cognitive processes shape trade policy preferences. This chapter starts with a discussion on LIG, NF, and behavioral approaches to understanding trade preferences. It then delves into the Eurobarometer data on the shifting preferences and concludes with a discussion on some of the forces that explain the differing rebounds of trade openness post-crisis.

Liberal Intergovernmentalism versus Neo-Functionalism on Free Trade

The dynamics of free trade policies within the EU have long been a subject of scholarly debate, with two prominent theoretical frameworks providing contrasting perspectives: LIG and NF. While both theories acknowledge the importance of economic integration and the role of institutions, they diverge in their underlying assumptions and explanations for the evolution of free trade policies.

Liberal Intergovernmentalism:

LIG, pioneered by Andrew Moravcsik (1993, 1997; Moravcsik and Schimmelfennig, 2009), emphasizes the primacy of nation-states and their rational pursuit of economic interests. According to this theory, free trade policies within the EU are driven by the collective bargaining power of member states with each member state seeking to maximize their national economic interests. LIG posits that states are the primary actors in the decision-making process, acting as unitary rational actors guided by their domestic economic interests.

Under the LIG lens, the development of free trade policies within the EU is seen as a series of intergovernmental bargains, wherein member states negotiate and strike deals that align with their national economic interests. The theory explains the evolution of free trade policies as a result of interstate bargaining, with the most powerful states exerting greater influence over the negotiation process and policy outcomes. Critics of LIG argue that it oversimplifies the complexities of policymaking within the EU by treating states as unitary actors and overlooking the influence of domestic political dynamics, interest groups, and supranational institutions. Additionally, the theory's emphasis on economic interests fails to account for the role of non-economic factors, such as cultural and social identities, in shaping trade policy preferences.

Neo-Functionalism:

In contrast to LIG, NF presents a more institutionalist perspective on the integration of free trade policies within the EU. Developed by scholars like Ernst B. Haas (1958) and Leon Lindberg (1963), NF posits that economic integration in one sector (e.g., trade) creates functional pressures for further integration in related sectors, driven by the spillover effects of interdependence.

According to NF, the process of economic integration within the EU is driven by supranational institutions and interest groups, rather than solely by nation-states (Schmitter, 1969; Sandholtz and Stone-Sweet, 1998; Risse, 2005; Niemann, 2006). These institutions and interest groups, such as the European Commission or the ECB, play a crucial role in promoting further integration and shaping free trade policies. NF argues that the process of economic integration creates a self-reinforcing dynamic, where successful integration in one area generates demand for further integration in related areas. This spillover effect is facilitated by the activities of supranational institutions and interest groups, which advocate for deeper integration and promote the harmonization of policies across member states.

Critics of NF argue that it overestimates the autonomy and influence of supranational institutions, while underestimating the role of nation-states in shaping free trade policies. Additionally, the theory's focus on spillover effects and functional pressures may overlook the influence of political factors, such as national sovereignty concerns and domestic interest group dynamics.

Both LIG and NF offer valuable insights into the dynamics of free trade policies within the EU, but they also have limitations and areas of divergence. LIG provides a state-centric perspective that focuses on the importance of national economic interests and interstate bargaining in shaping trade policies. However, it may oversimplify the complexities of policymaking by treating states as unitary actors and overlooking the influence of domestic politics and non-economic factors. In contrast, NF emphasizes the role of supranational institutions and interest groups in promoting economic integration and harmonizing policies across member states. It acknowledges the

spillover effects of interdependence and the self-reinforcing nature of integration processes. However, critics argue that it may overestimate the autonomy of supranational institutions and underestimate the influence of nation-states.

Behavioral Approach

The behavioral approach to understanding trade policy preferences within the EU emphasizes the role of individual-level factors, social identities, and cognitive processes in shaping attitudes and preferences. SIT argues that individuals derive a significant portion of their self-concept and sense of belonging from their membership in various social groups (Mercer, 1995). These social identities can be based on factors such as nationality, occupation, gender, or any other salient group affiliation. In the context of trade policy preferences, SIT argues that individuals will tend to favor policies that are perceived as benefiting or protecting the interests of their salient in-groups.

AT focuses on how individuals attribute causality to events and outcomes (Mercer, 1996). In times of economic crises or trade-related disruptions, individuals may attribute the causes to either situational factors (external forces beyond their control) or dispositional factors (internal characteristics or behaviors of themselves or others). The attribution of causality can significantly influence subsequent attitudes and policy preferences, including those related to trade. Adam Smith's Theory of Moral Sentiments highlights the role of empathy in shaping human behavior and decision-making. According to this theory, individuals have an inherent capacity for empathy, which allows them to resonate with the experiences and perspectives of others, specifically those within their in-groups. In the context of trade policy preferences, empathy may lead individuals to

support policies that are perceived as benefiting or protecting the well-being of their in-group members.

The Data

The Eurobarometer survey, conducted by the European Commission, serves as a valuable resource for monitoring public opinion across EU member states and candidate countries over time. This dissertation utilizes data from the 2005, 2006, 2007, 2009, 2010, 2014, 2015, and 2019 waves of the Eurobarometer, providing a comprehensive dataset spanning from prior to the crisis, the depth of the crisis, over a decade post-crisis. The combined dataset consists of 239,528 observations. These observations are drawn from respondents across various EU member states and candidate countries, offering a broad geographic representation. These years were chosen as they were the specific years where the same question on sentiment toward free trade was asked.

The free trade “concept image” asked was:

“Could you please tell me for each of the following, whether the term brings to mind something very positive, fairly positive, fairly negative or very negative.”

- *Free Trade*

The Eurobarometer datasets encompass a rich set of demographic variables, including age, gender, education level, and occupation, among others. These variables allow for the identification of systematic patterns and correlations that shape viewpoints on open market policies across different socioeconomic groups. By combining these waves of the Eurobarometer survey, I am able to explore a comprehensive dataset spanning the duration of the crisis.

Changes in Free Trade Preferences

Figures 1 and 2 demonstrate a near across the board reduction in openness to free trade amongst the countries surveyed by the Eurobarometer in 2007 and 2009, the year directly before, and the year ensuing financial crisis. As Europe reeled from the financial crisis and the ensuing sovereign debt crisis, it is not surprising that individuals and groups would turn more inward and prefer policies to insulate their economy. In this case, that economy is that of the Schengen Area. While the general movement against free trade is not a discriminating test of the three theories in and of itself, it does set us up to look more closely at the determinants of these views.

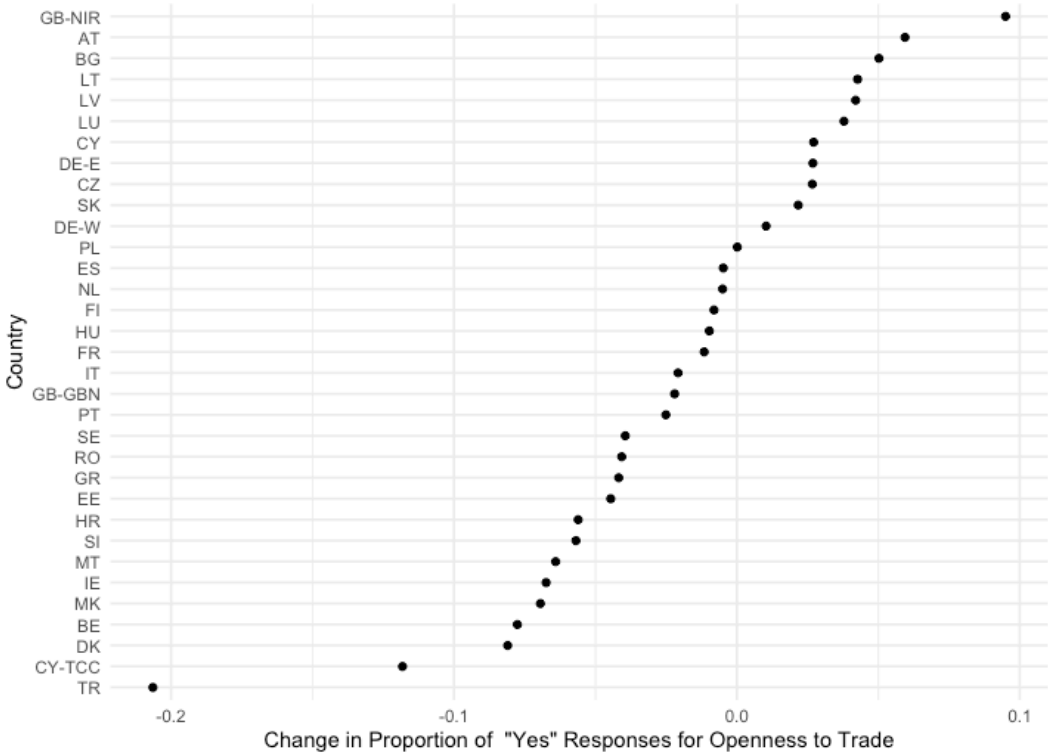


Figure 1: Change in Openness for Free Trade (2007-2009)

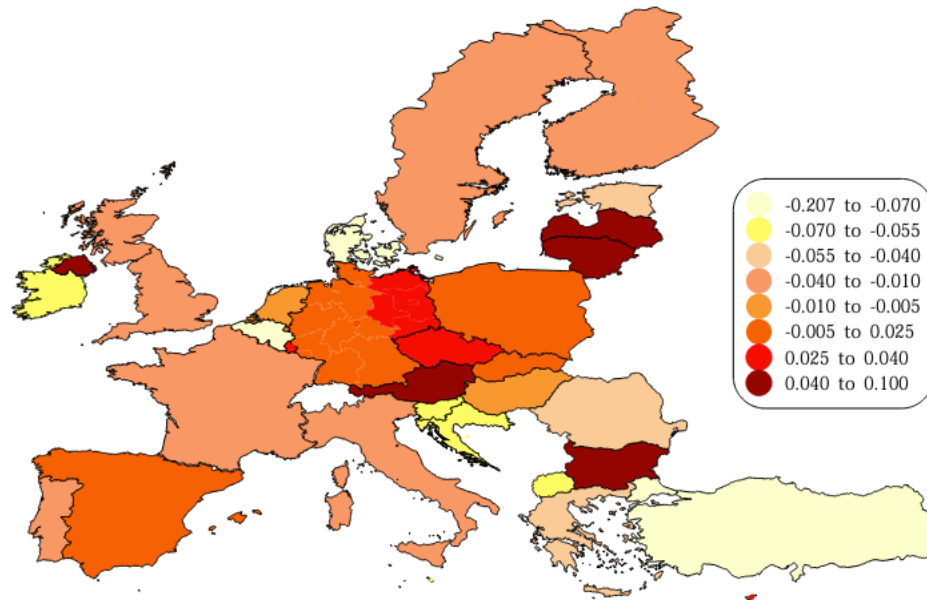


Figure 2: Change in Openness for Free Trade (2007-2009)

Figure 3 depicts regional trends in positive trade sentiment from 2005 to 2019 and provides a more nuanced view of the changes in trade attitudes across different parts of Europe. This visualization complements and extends the observations made in Figures 1 and 2, offering a deeper understanding of the impact of the 2008 financial crisis and subsequent sovereign debt crisis on public opinion regarding free trade. One of the more important features of Figure 3 is the sharp decline in positive trade sentiment observed across all regions in 2010. This widespread reduction in support for free trade aligns with the initial discussion of Figures 1 and 2, confirming a near-universal shift in attitudes following the 2008 financial crisis. The consistency of this decline across diverse regions of Europe - from the economically robust Northern Europe to the more “vulnerable” Southern Europe underscores the profound and pervasive impact of the crisis on public sentiment.

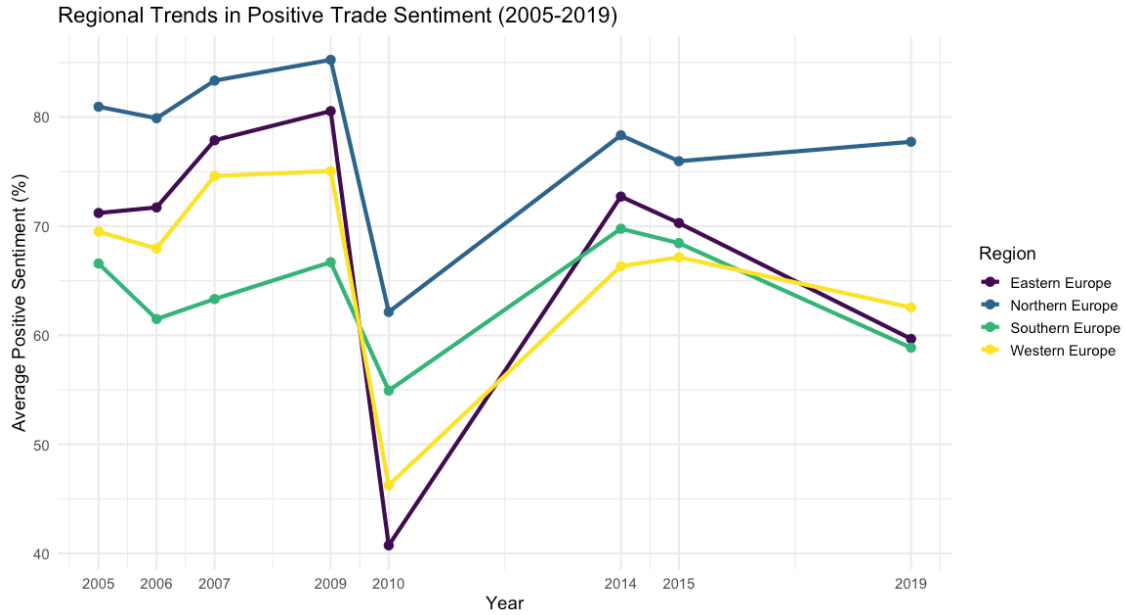


Figure 3: Change in Regional Openness for Free Trade (2005-2019)

This common trajectory, despite varying starting points and recovery patterns, speaks to the power of significant exogenous economic shocks to reshape public opinion on a continental scale. The financial crisis and its aftermath triggered a collective reevaluation of trade policies across Europe, leading to a widespread preference for more protectionist stances. This shift likely reflects a common desire among European citizens to insulate their economies from perceived external threats and instabilities. The uniformity of this initial response is particularly noteworthy given the typically divergent economic experiences and policy approaches of these regions. Northern Europe, despite its generally stronger economic position, shows a decline in positive trade sentiment parallel to that of Southern Europe, which was more severely impacted by the crisis. This suggests that the psychological impact of the crisis on trade attitudes superseded immediate economic circumstances, pointing to a broader shift in perceptions about the benefits and risks of open trade policies. This is not to say that psychological approaches only out-compete

rationalist models when looking at irrational decision-making, or that the movement against free trade during crisis is irrational.

While the recovery patterns diverge in the years following 2010, with some regions rebounding more quickly than others, the initial downturn remains a defining feature of the data. This common experience sets the stage for a deeper exploration of the factors driving these changes in trade sentiment. It raises questions about the role of media framing, policy responses, and public discourse in shaping and perpetuating these attitudes in the years following the crisis. The widespread nature of this shift in trade sentiment also challenges simplistic explanations based solely on national economic interests or regional disparities. Instead, it points to the need for a more nuanced theoretical approach that can account for both the shared experience of crisis and the varying paths of recovery. This reinforces the value of a behavioral perspective in understanding how individuals and societies process and respond to economic shocks, and how these responses manifest in changing attitudes towards trade, economic integration, welfare policies, and deeper integration.

Figure 4 presents an aggregated visualization of the trend in positive trade sentiment across the EU and UK from 2005 to 2019. This graph offers a clear and concise representation of the aggregate shifts in public opinion towards free trade over this period. Again, the most striking feature of this chart is the dramatic decline in positive trade sentiment between 2009 and 2010. This decline coincides with the aftermath of the 2008 global financial crisis, illustrating the impact of this economic shock on public attitudes towards trade. The severity of this decline - from a peak of nearly 75% positive sentiment to a low of about 47% - underscores the magnitude of the shift in public opinion during this turbulent time.

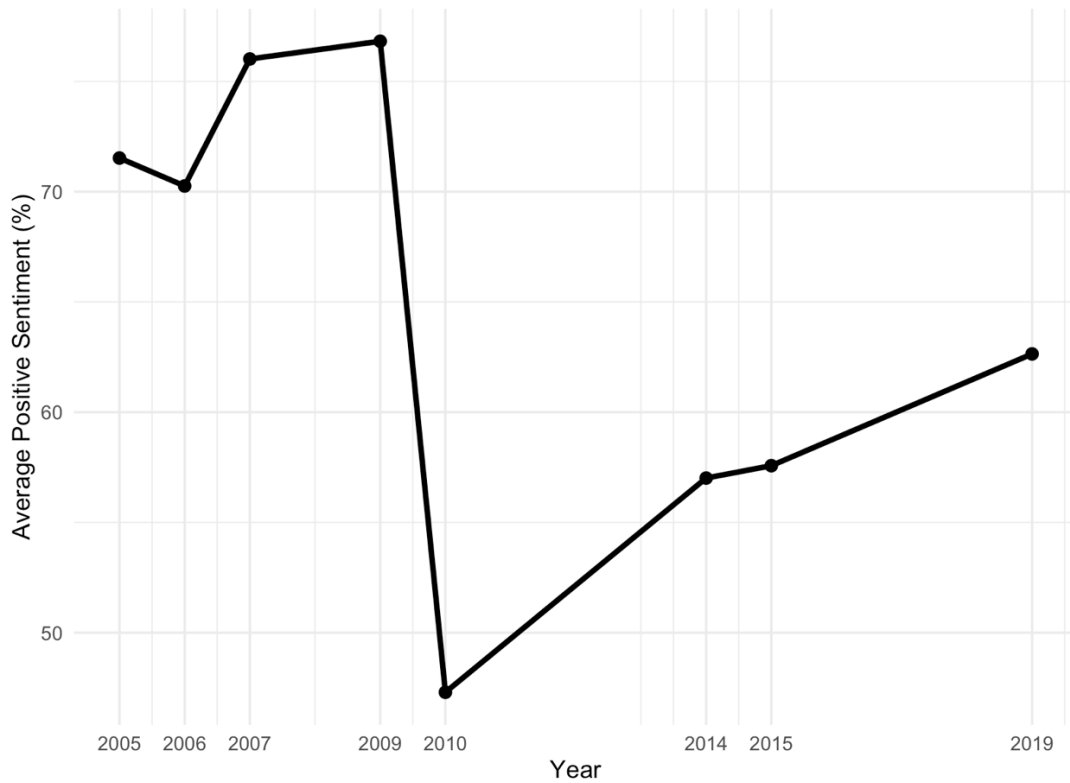


Figure 4: Aggregate Change in Openness for Free Trade in EU and UK (2005-2019)

Prior to the crisis, the Figure 4 shows a generally stable and slightly upward trend in positive trade sentiment from 2005 to 2009. This suggests that, in the years leading up to the financial crisis, there was a gradual increase in support for free trade policies across the EU and UK. The sudden reversal of this trend in 2010 highlights how quickly and dramatically public opinion can shift in response to major economic events. The post-2010 period reveals a gradual recovery in positive trade sentiment. However, it's notable that by 2019, the level of positive sentiment had not yet returned to its pre-crisis peak. This suggests a lasting impact of the financial crisis on public attitudes towards trade, even nearly a decade after the initial shock.

The steady upward trajectory from 2010 to 2019 is particularly interesting. It indicates a slow but consistent rebuilding of confidence in free trade policies across the EU and UK. This gradual recovery may reflect the complex process of economic stabilization and policy adjustments implemented in the wake of the crisis. This overall trend provides crucial context for understanding the more nuanced regional variations discussed earlier. It serves as a backdrop against which we can interpret the diverse experiences and responses of different European regions and countries. The aggregate view presented in Figure 4 reinforces the narrative of a widespread shift in trade attitudes following the 2008 crisis, while also highlighting the long-term nature of attitudinal changes in response to major economic events.

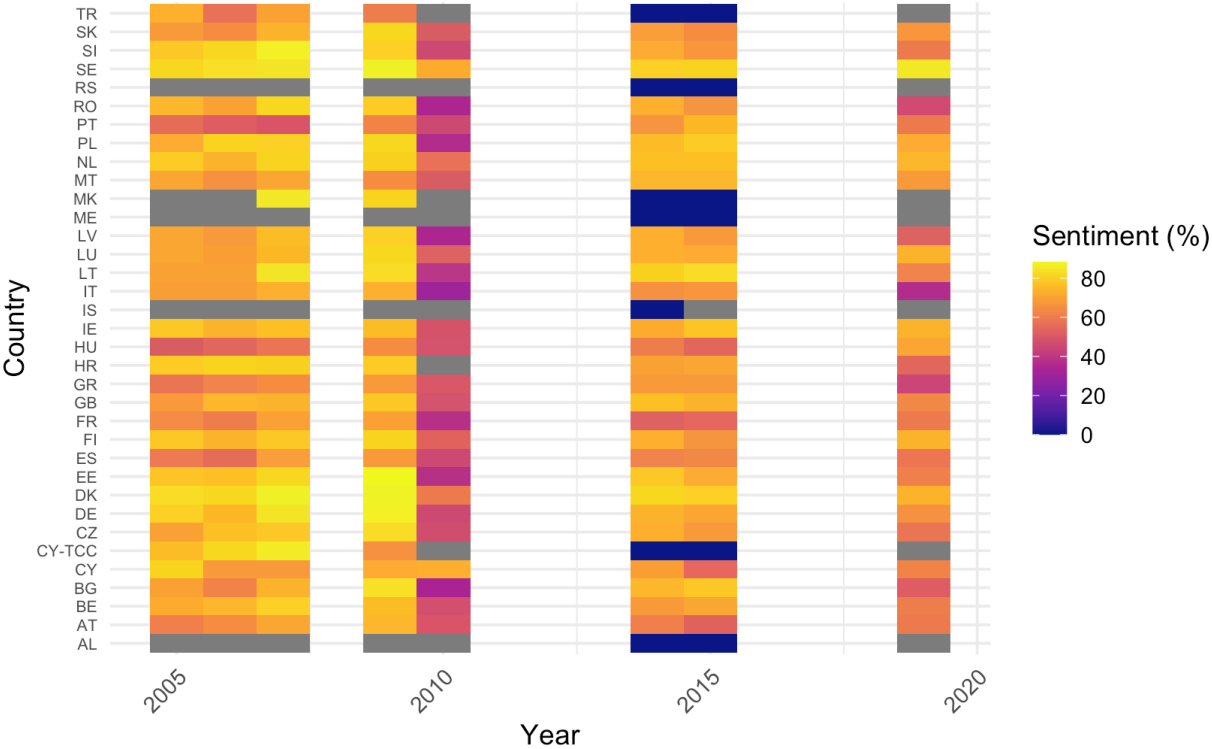


Figure 5: Heatmap Plot of Changing Trade Preferences in Europe (2005-2019)

The heatmap in Figure 5 further illustrates the changing preferences for free trade before, during and after the global financial crisis using more than just the EU and UK as data points. Each column represents a different year, the white columns are years in which the Eurobarometer did not ask the same question about free trade, and grey coloring represent missing data. Examining the years leading up to 2010, particularly the 2005 column, we see generally positive sentiment across most countries, indicated by the predominance of yellow and orange colors. This reflects the economic optimism of the pre-crisis years, a stark contrast to the abrupt shift observed in 2010. The dramatic change from optimism to pessimism underscores the severity of the economic shock and its effect on public perception.

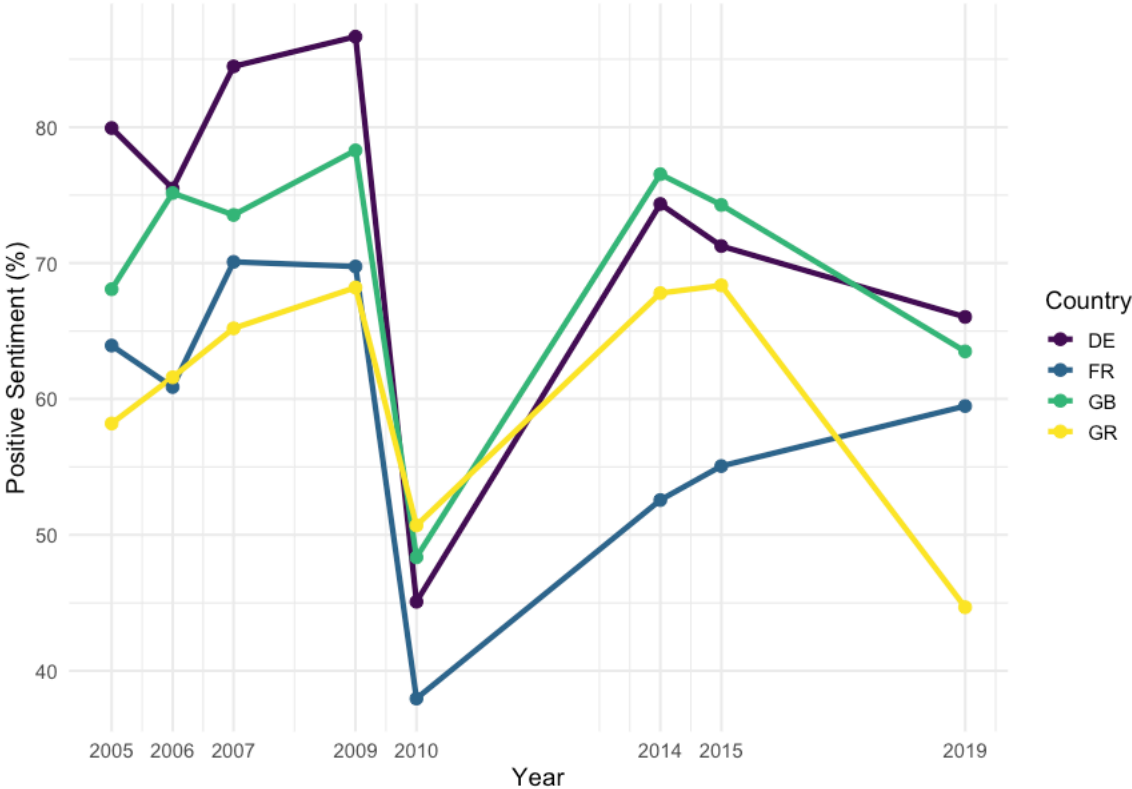


Figure 6: Change in Openness for Free Trade in Germany, France, The UK, and Greece (2005-2019)

Figure 6 provides a more detailed look at trade sentiment trends for Germany (DE), France (FR), Great Britain (GB), and Greece (GR) from 2005 to 2019. This narrower view reveals both shared patterns as well as distinct trajectories among these key European economies, representing a cross section of EU, Non-EU, debtor, and creditor states. All four countries exhibit a sharp decline in positive trade sentiment between 2009 and 2010, mirroring the overall trend observed in previous figures. This reinforces the widespread impact of the 2008 financial crisis on trade attitudes across diverse European economies. However, the depth of this decline and the subsequent recovery patterns vary among these states.

Viewing these trends through the lens of SIT and AT offers a nuanced perspective on the evolving trade sentiments across these nations. The initial decline observed in all countries can be understood as a manifestation of heightened national identity salience and empathy for compatriots in the face of economic crisis. This shared experience likely strengthened in-group cohesion within each nation, temporarily overshadowing broader European identity.

Germany's trajectory, starting from the highest level of positive sentiment and showing strong recovery, suggests a resilient national identity that quickly reframed the crisis as an external threat. The robust economic performance may have reinforced a positive in-group image, allowing Germans to attribute their recovery to internal strengths rather than external factors. This positive self-attribution could explain the maintenance of high levels of trade sentiment. France's deeper decline and slower recovery point to a more complex interplay of identity and attribution processes. The prolonged dip in positive sentiment might indicate a stronger tendency to attribute domestic social changes, and government movement towards deconstructing the social safety nets to globalization and free trade. This out-group attribution could have reinforced a more

protectionist stance, slowing the recovery of positive trade sentiment. The UK's pattern reveals a fascinating shift in identity dynamics. The strong recovery post-2010 suggests an initial attribution of the crisis to external factors, with trade seen as a solution rather than a threat. However, the decline after 2015 coincides with Brexit discussions, indicating a significant shift in social identity. This could reflect a strengthening of national identity over European identity, with economic challenges increasingly attributed to EU membership and trade policies. Greece's volatile pattern illustrates the profound impact of crisis on national identity and attribution processes. The initial sharp decline likely reflects a strong in-group focus and attribution of problems to external factors. The recovery to 2015 might indicate a period of renewed trust in European solutions. However, the steep drop-off to 2019 suggests a resurgence of national identity concerns, possibly fueled by attributions of austerity measures to out-group (EU) decisions.

These varied patterns highlight how social identity and attribution processes can significantly influence trade sentiments in different national contexts. While all countries experienced the initial shock of the 2008 crisis, their divergent recovery paths reflect distinct ways of negotiating the balance between national and European identities, as well as differing attributions of economic successes and challenges. As we proceed to analyze media framing and policy responses, it will be crucial to consider how these identity dynamics and attribution processes shaped public discourse and policy preferences. The interplay between in-group/out-group perceptions, attributions of economic events, and the framing of trade policies in national media likely played a significant role in the evolution of trade sentiments across Europe during this tumultuous period.

Conclusion

The analysis of trade sentiment across European countries from 2005 to 2019 provides compelling evidence of a significant and widespread shift in public attitudes towards free trade, particularly in the wake of the 2008 financial crisis and subsequent European sovereign debt crisis. This examination of trade preferences not only illuminates the immediate impact of economic shocks on public opinion but also reveals the complex, long-term dynamics that shape attitudes towards economic integration and globalization. The universality of the negative sentiment shift observed in 2010 across diverse European nations underscores the profound and far-reaching consequences of the economic crises on public perceptions. This uniform downturn, followed by varied recovery patterns, supports the broader argument that trade preferences are not solely determined by rational economic calculations or institutional factors. Instead, they are deeply influenced by psychological and social dynamics, as posited by the behavioral approach.

The persistence of altered trade sentiments in many countries up to 2019 demonstrates that major economic events can have lasting effects on public attitudes, potentially reshaping the political landscape for trade policies in the long term. This finding has significant implications for policymakers and scholars alike, suggesting that the aftermath of economic crises may require sustained efforts to rebuild public trust and support for open trade policies. Moreover, the country-specific variations in sentiment recovery highlight the importance of national contexts, including how governments and media frame economic challenges and policy responses. These differences support the argument that social identity salience, attribution of crisis causes, and economic narratives play crucial roles in shaping trade preferences.

Within the larger context of the project, these findings contribute to a more nuanced understanding of the political economy of preference formation. They demonstrate that public opinion on trade is not static but rather dynamically shaped by economic events, social identities, and narrative framing. This perspective challenges simplistic notions of economic self-interest as the primary driver of trade preferences and underscores the need for multifaceted approaches to studying and formulating trade policies. Ultimately, this chapter reinforces the central argument of our dissertation: that understanding economic preferences during times of crisis requires a holistic approach that considers economic, psychological, and social factors. As Europe and the world continue to face economic challenges and debates over globalization, this nuanced understanding of public attitudes towards trade will be crucial for crafting effective and sustainable economic policies that can garner broad public support.

Chapter 4: States, Crises, and Frames

*On résiste à l'invasion des armées; on ne résiste pas à l'invasion des idées.
One [may] resist the invasion of armies; one does not resist the invasion of ideas.
- Victor Hugo, Histoire d'un Crime, 1877*

Ideas can be as powerful as the strongest army or the deadliest disease. Ideas and beliefs about others shape our identities and play a pivotal role in shaping our policy preferences. Chapter 2 focused on the role of empathy and identity in shaping how we form groups and on how group formation shapes how we view and explain the actions of others. These explanations depend on whether the person, or a group of people, are members of your in-group or the out-group. Group membership shapes whether we describe the actions of others as due to situation or disposition. Did they commit a heinous act because it is their character, or their disposition, to do so? Or did they commit the act because they had no choice? Was it the situation? This chapter builds on theory laid out in chapter 2, and the discussion on changing preferences during times of crisis in chapter 3 by providing empirical support for AT. SIT explains how groups form, here I focus on AT in demonstrating the competing narratives that exist when considering the cause of the financial crisis. Questions of cause are critical when considering which policies need to be enacted. Chapter 5 builds on this by focusing on the policies enacted by the European Union in response to the financial crises.

Building on the dissertation's larger question of what explains the EU's diverging response to the sovereign debt and financial crises, this chapter focuses primarily on the question: what explains the diverging frames surrounding the financial crisis? Understanding how the crises were discursively constructed allows us to understand why the EU and its member states responded to the crisis as it did. The underlying beliefs of individuals or groups of individuals regarding others

shapes the way they understand situations, be they everyday events or crises of a political or economic nature. Such beliefs shape how individuals understand new information and form frames. Understanding framing effects allows us to better understand state responses to the crisis; the way the crisis is framed affects the way it is approached. In approaching this question, the chapter focuses on issue framing and AT. How one interprets a crisis establishes beliefs as to "cause," and thus allows people to establish beliefs as to the best solution. By this I mean, how people come to form opinions as to what caused the crisis, informs them as to how the crisis should be responded to. This chapter aims to show the need of taking a multidisciplinary approach in understanding the effects of financial crises on various polities. Extant theory in political economy, LIG in particular, does not adequately account for the relationship between beliefs and framing effects. Indeed, how people frame or interpret an event explains how people respond to that event. This chapter focuses primarily on the European sovereign debt crisis and examines the framing of the crisis within France, The UK, Germany, Greece, Norway, and Spain. I will first provide a brief review of the Eurozone and the financial crisis. I then discuss existing theories of political economy and regional integration to develop an understanding of how others have described the relationship between beliefs and interests. From there I will further discuss the relationship between SIT and AT, pulling in insights from psychology and behavioral economics. The next section will discuss case selection, and the method of "text as data" in a quantitative manner. The following section discusses the results, and the last section concludes.

The Crisis and Crisis Framing

Following the implementation of the Euro as an accounting currency in 1999, EU member states were graced with low interest rates when selling sovereign debt on the bond markets.

Countries such as Greece, Italy, and Spain enjoyed artificially lowered bond yields (De Grauwe and Ji, 2012), while Germany enjoyed more competitive real effective exchange rates (REER) due to its low consumption and wage inflation (Caporaso and Kim, 2012). Indeed, prospects of continued growth seemed to be a given, rather than a hope. This all ended abruptly with the collapse of housing markets in both the EU and the United States. Additionally, new facts were revealed concerning Greek solvency, leading to a rise in bond yields for not just Greece, but for other southern European states as well. Investors lost confidence in the seemingly economically backward states of southern Europe resulting in a contagion effect and thus capital flight (Drudi, Durre, and Mongelli 2012).

The problems of Greece come as a stark contrast to its southern neighbors. Greece had kept two separate sets of financial books. One that had been released publicly regarding its levels of debt; the other had been kept privately and reflected Greece's true levels of debt (Buti and Carnot, 2012). Greece, unlike some of its counterparts, suffered from very high levels of public debt. By 2008, public debt had risen to approximately 109% of its Gross Domestic Product (GDP). Since 2008, Greece's GDP has plummeted while its debt levels have increased to nearly 180% of its GDP in 2014 (Eurostat). Greece's rising deficits in 2008 and 2009 led to additional fears of a Greek default. Greece had accumulated many civil servants while being unable to develop a large-scale industrial capacity. The Greek government had to borrow, both domestically and internationally, to finance its growing public sector -- with a debt-GDP ratio climbing from 20% in 1975 to 109% in 2008 (Ibid; Matsaganis, 2012; Eurostat). Greece's pre-crisis financial woes were largely brought on by its inability to collect taxes, its relatively high levels of wage inflation compared to other

Eurozone states, and a bloated bureaucracy. Greece seemed to the poster child for profligacy, and the northern states used this as rationale in their drive for austerity as the key response.

Spain on the other hand ran budgetary surpluses through 2007 and managed to lower its debt-GDP level from 58% in 2000 to 35.5% in 2007 (Eurostat). Spain and Greece had very separate problems, while Greece has been marred with high levels of government spending and lax tax collections, Spain's problems came from high levels of private debt and a housing bust (Fishman, 2012; Kennedy, 2011). Indeed, Spain was one of the few countries in line with the SGP's guidelines limiting member state's debt-GDP levels to no more than 60% and annual budget deficits to no more than 3% -- guidelines that even Germany had not followed (McGiffen, 2011: 38; Buti & Carnot, 2012: 900; Commission, 2012). Spain, like Ireland, fell prey to the credit crisis following the collapse of the US housing market. Spain's economy was devastated when cheap credit stopped flowing into Spain's economy, which had been built upon cheap credit and a housing boom. Spanish unemployment skyrocketed and eventually the government was forced to step in to bailout its banking and financial sector. In response to the bailing out of its domestic economy, the Spanish government needed to be bailed out. Spain was forced to borrow from its northern neighbors because of the lack of its own independent central bank to print money, control interest rates, or devalue their currency.

As we can readily see, the causes of crisis within the various Eurozone member states are unique yet intrinsically connected through a common monetary policy and regulatory framework. While the causes of crisis remain independent, ranging from high levels of private debt in Spain

to high levels of public debt in Greece, we see a common public belief in Germany regarding the causes of the South's economic woes.

Within Germany we see an overarching discourse: that the crisis was caused by the profligate spenders in the south who sought to provide overly generous welfare and labor programs without the capacity to fund them. Within Greece we saw a very different discourse: the crisis is a result of the financial system itself as well as the banking practices of unscrupulous lenders, and not the fault of its own policies. Indeed, both sides see themselves as a victim of the poor behavior of their counterparts. Such discourses logically lead to varying ideas concerning crisis response. While the dominant frame that shaped the crisis response was that held by Germany, we cannot blindly accept it as being the most accurate one. Power obviously plays a role in such cases; after all, the states shaping the response are the ones with the ability to fund such a response. Therefore, I make no claims as to which frame or public discourse is correct, rather I seek to demonstrate the role of identity, beliefs, and frames in shaping policy responses.

Beliefs and Interests

There has been great discussion in academic literature concerning the relationship between ideas, or beliefs, and interests. Do beliefs precede interests, or do interests come first? Rational choice theorists see the latter, both states and individuals are working to maximize their utility. As Shepsle (1985: 235) wrote, “ideas are vehicles or instruments that politicians use to further their own objectives.” Arguments such as this imply that the way in which crises or political decisions are framed publicly does not reflect the true rationale behind decision-making but act as a disguise through which actors can attain their intended goals. Here ideas and frames are seen as instrumental

tools used by the political elite to allow them to pursue their policy preferences. In the case of Europe's sovereign debt crisis, we would see the dominant frames in the crisis as reflections of elite interests rather than underlying ideology and beliefs; the frames would be seen as tools used by the elite in order to get public opinion to go along with their particular policy interests. As Shepsle refers to the phenomena, it is the political elite using popular ideas as hooks to “propagate and to legitimize” their interests.

In the realm of European integration, Moravscik (1998: 7) sees the process as one stemming from economic interests. It is from domestic interest groups that the political elite form policy preferences, claiming "economic interests, moreover, determined the circumstances under which geopolitical ideology could influence policy," later claiming that only in cases where economic interests were “weak, diffuse, or indeterminate” does ideology play a role. That is, ideology and beliefs do matter to an extent, but the interests of domestic groups play the key role in determining what is and is not in the best interest of the state (or more specifically in the interest of key actors within the state; business leaders, banks, industry). Moravscik’s LIG, the dominant theory of European integration falls within the rational choice framework. An example of LIG theory can be seen in the creation of Europe's economic and monetary union; economic integration was the result of domestic pressures to increase trade through the lowering of tariffs and other barriers rather than from normative ideas stemming from a European identity or a desire for an “ever closer Europe.”.

Rational choice arguments such as Moravscik’s rely on the ability of leaders to forecast the outcomes of their decisions -- leaders do not choose which policy to pursue out of an ideological

desire but out of a normative calculation as to what policy is most likely to yield the greatest return for the state. Prior held beliefs and biases play no role in a universe dominated by clear information, powerful interest groups, and pressures for security and economic maximization. While many rational choice theorists will admit that such assumptions do not always hold, and that there are indeed informational asymmetries, their argument remains that such simplifications tell us how preferences form on average (Moravcsik, 1993, 1998).

Goldstein and Keohane (1993) explore the power of ideas in shaping policies. Here, ideas are seen as causal factors in how actors look at and interpret national interest. In Goldstein and Keohane's edited volume, Robert Jackson (1993) looks at the example of decolonization, arguing that the impetus for decolonization stems not purely from rational cost-benefit calculations but from a changed belief system and the rise of the sentiment for self-determination. While Jackson does not dismiss the role of rational calculations, he argues that the roles of ideas and norms comes to the forefront.

To those who see beliefs and ideas as preceding interests, prior held beliefs allow rational actors to make decisions when there is uncertainty regarding information. That is, when there are multiple policy options at hand, and information asymmetries exist, individuals rely upon their beliefs and ideologies when deciding on the best policy option moving forward. This paper holds that it may be true that frames and interests may often overlap, the importance here is that interests are derived from ideology. German preferences for austerity as opposed to stimulus spending stems from their normative, ordoliberal, belief that strict monetary policy and domestic fiscal

responsibility will lead to a sounder Eurozone. Such preferences stem from how the crisis is framed and the beliefs surrounding the crisis. Beliefs precede preferences.

I see frames as being the result of individually held beliefs manifesting themselves in a manner that shapes the way in which people view life. Therefore, I see beliefs and frames as being closely intertwined concepts that inform individuals as to how one should interpret new information, respond to events, and indeed lead one's life. Beliefs and frames are not non-malleable components of one's being but are relatively stable ideas about how the world and life in general operate. They are the product of inter-group and inter-personal interactions and relationships. Beliefs and frames shape the way in which people "update" their preferences when provided with new information in a way that strongly differs from Bayesian concepts of rationality. While individuals may try their best to be objective in their decision making, attempts at objectivity are often thwarted by underlying paradigmatic biases. Rationalists argue that individuals have their own sets of ordered and transitive preferences, though the ability to leave out beliefs and biases from the decision-making process is incredibly difficult, perhaps impossible. As Tversky and Kahneman (2000: 210) point out: "the deviations of actual behavior from the normative model are too widespread to be ignored, too systematic to be dismissed as random error, and too fundamental to be accommodated by relaxing the normative system." Two individuals, or two states, can be given the exact same piece of information but interpret the information in a different manner based upon their underlying beliefs and thus the framing of the situation.

In the case of Germany, we see the pervasiveness of ordoliberal beliefs affecting the way in which they understand the financial crisis. While the German government was quick to provide financial stimulus domestically, they cried foul when approaching the financial problems of other

European states. The ordoliberal views, which came about during the Nazi period as a protest against the planned economies of the day, do not coincide with the domestic Keynesianism that occurred during the outbreak of the crisis, but their tenets have been quickly applied externally. Ordoliberalism is most concerned with the provision of a rule-based economic order (Blyth, 2013).

Kenneth Dyson (1999) additionally points to the role of German ordoliberal ideology in framing the EMU -- Germans did not believe that French or other concepts of a monetary union would be viable. A non-politicized central bank, and open competitive markets were key. Dyson points out the German memory of hyperinflation in the interwar period as being one of the keys in shaping how they view fiscal and monetary policies. The market should be left to its own accord, but within a strict system of rules set forth by the government. While this chapter does not investigate how German's referred to their own domestic problems (be they situational or dispositional in nature), we have seen that the German federal government has always been quick to bailout its state governments when in need. The German identity and fealty is a strong one. As Blyth (2013: 143) points out, the German mantra of "*Erst sparen, dann kaufen* (first save then shop) leaves no room for the profligate except austerity, and it allows no room for compensation apart from policies that speed the adjustment of the market." Thus, here too we see the role of underlying ideologies leading to the formation of policy according to prior held normative beliefs as to how the economy ought to be structured. Furthermore, Douglass North (1990: 44) points out "ideas, organized ideologies, and even religious zealotry play major roles in shaping societies and economies." Indeed, normative ideas and ideologies cannot be separated out from economic practice or institutions. They play a constitutive role in forming the institutions that govern our

social and economic relationships. Ideas and normative beliefs are at the base of every decision we make.

Social Identity, Frames, and Attribution Theory

Frames are not monoliths. They arrive when an individual is presented with new information which is then read through prior held beliefs. That is, beliefs precede frames. One holds a general belief as to how society functions regardless of how much information one holds on the subject matter. Once provided with new information one can form frames based upon prior held beliefs. We see in social psychology (see Mlicki and Ellemers, 1996; Ellemers, Kortekaas, and Ouwerkerk, 1999; Simon, and Klandermans, 2001) how in-group vs out-group relations from SIT envisage stereotypes and therefore affects policy outcomes. The role of stereotypes is important in establishing expectations for intergroup relations. Stereotypes are simply widely held and oversimplified views that individuals can hold about other individuals or groups. Stereotypes play an important role because they are widely held (Jervis 2017; Mercer 2023). They can play an oversized role in shaping how we view the actions of others. Negative (Schimmelfennig, 2015) stereotypes about the out-group only serve to further strengthen the dispositional explanations one may employ when explaining their actions.

In the context of the Eurozone crisis, it is the stereotypes held in the north of those in the south that affects how they view the crisis, and the stereotypes held in the south of those in the north affects their views on crisis response. The views, and beliefs, held in the north of those in the south precedes the financial crisis and serves to reinforce their prior held beliefs. Such stereotypes within Europe are not the result of the crisis, but precede the crisis. The European

Commission published a qualitative survey in 2001 that it had commissioned to learn more about public attitudes toward the EU. The study wrote: “**Northern member states have only weak empathy with other Europeans, particularly with those from the south** (emphasis in original), whose mentality is seen as very different, and who are even quite overtly despised (for not being responsible, hard-working, orderly, etc.)” (European Commission, 2001: 5). Regardless of whether such a statement may be true, we see in 2001, before the crisis, and we see in 2008, mid-crisis, the same rhetoric regarding the beliefs of northern states vis-à-vis those in the south.

AT helps us to better understand the different arguments being made regarding northern or southern states and their economic performance based upon which group one belongs to. For instance, the AT would expect those in the north to attribute situational frames to those in the south when their economies are doing well (e.g. a rising tide raises all boats) and dispositional frames when their economies are not doing well (e.g. the nature of their people and government). While northern states are expected to assign dispositional frames to their counterparts when their economies are doing well (e.g. their hard-working people and educational system has paid off) while situational attributes are expected to be used when their counterparts are not doing well economically (e.g. they were dragged into the crisis).

These beliefs have a profound effect on the framing of crises when they occur. Prior held beliefs shape the interpretation of new information. From here we can construct three hypotheses:

- **H1:** Borrowers will frame the cause of their economic woes using situational qualities.
- **H2:** Lenders will frame the cause of the crisis using dispositional qualities vis-à-vis the periphery.

- **H3:** Outsiders will frame the cause of the crisis using situational qualities vis-à-vis the Eurozone.

The first hypothesis expects Europe's periphery to frame the crisis using situational terms in the sense that the crisis was brought about not by any fault of their own, but due to exogenous shocks. Arguing furthermore that the effects of the crisis were exacerbated by the limitations set forth by the stability and growth pact and the strict fiscal regulations set forth by the core states. Such an expectation means that I expect to find situational attributions being applied to questions concerning the cause of the crisis, and dispositional attributions being applied to questions concerning the initial response to the crisis. Greece, Italy, Ireland, Portugal, Spain (GIIPS) countries will see themselves as the victim of largely situational circumstances -- framing here will focus on the nature of the EMU, the US housing bubble and eventual contagion effects rather than on their own domestic problems as being contributory factors.

The second hypothesis expects a dispositional frame to be used in explaining the cause of the crisis. Mass publics within states such as Germany or France are expected to frame the crisis as being the fault of what are seen as the feckless, and profligate states in the south. Specifically, the German public is expected to frame the situation writ large as due to the dispositional characteristics of those southern polities -- the people themselves as well as their institutions in the are seen as at fault. In contrast to rational choice expectations, this theory expects a more ideologically based response to form. Germany is not pushing for austerity measures and government reforms in order to secure quicker repayment of loan money, but to ensure a better functioning eurozone in the long-run. While I make no claims as to what reforms need to be made

in order to create an optimal currency area¹ (OCA) in Europe (or indeed whether or not the EU is already an OCA), rather I put forth the theory that the push for austerity and government reforms stems from the belief, held by those in the north such as Germany, that the countries in the core are the poster children for sound economies and those in the south need to follow suit. This follows the long-held existence of north-south biases and stereotypes held within Europe.

The third hypothesis expects those outside of the eurozone to explain the crisis using situational terms, framing the crisis as being the product not of any single country's failings, but as the result of the eurozone's failings as an institution. We see this view most fervently in countries such as Poland and the UK. We see such views adamantly pushed in the UK. They look at the financial crisis as the result of a union that would never be: a politically and economically incompatible group with diverging interests. While the EMU, and the use of the Euro in particular, are seen in negative light, the members themselves are seen as being stuck in a bad situation.

Such frames are the result of in-group and out-group formation and the stereotypes and biases the groups hold regarding one another. AT allows us to draw from the group formation that SIT would predict and develop hypotheses as to how we would expect each group to frame the crisis. AT relies on the biases (both motivated and unmotivated) held by people at either an individual or group level. The beliefs and biases held by one group or individual about another allow for heuristic shortcuts to be made in assessing changing situations. Such shortcuts at times allow for correct evaluations, and at times allow for incorrect evaluations, whether or not the

¹ See Eichengreen 1991 or Frankel & Rose 1996

shortcuts lead to correct evaluations is immaterial. What matters is the use of frames being central to the decision-making process.

Data and Methodology

I utilize newspaper articles from France, Great Britain, Germany, Greece, Norway, and Spain as the data sources for this chapter. I selected these cases as they represent key actors within the Eurozone who are most often referred to when discussing the crisis, being the key creditor states (France and Germany), two debtor states (Greece and Spain); the UK and Norway were chosen as they are both European states with deep ties to the Eurozone but are not Eurozone members themselves. These cases were also selected as their data were more readily available for use. Attempts were made to expand to other EU member states including Italy, Switzerland, and the Netherlands for a more robust analysis, but the large-scale collection of relevant data was not feasible due to their interfaces not allowing for the easy scrapping of the data. Specifically, I use *Adresseavisen*, *Le Figaro*, *El Pais*, *the Guardian*, *Die Zeit*, and *Kathimerini* newspapers. The text as data approach, using newspaper articles, works to demonstrate that the stereotypes and beliefs that came to form powerful frames that came to shape the policy response. While this chapter's focus is on demonstrating the importance of framing, framing effects, and showing that these frames are real and widely viewed, Chapter 5 works to show how these frames took hold in actual policy.

To collect relevant news articles, I conducted key term searches using an API (application programming interface) for the *Guardian* and the general websites for the other newspapers. The key terms I used were "Euro crisis," "Greek bailout," "Spanish bailout," "grexit," and "Italian debt

crisis.” In order to maximize the number of articles of relevance I did not use direct translations from English to the national language, but used phrases that were more contextually specific to the country while also searching for the same general meaning. For example, the German newspapers tend to refer to the concept of "bailout" as “Hilfsprogramm” which translates to English as “help program.” This is, of course, not the same as bailout in the literal sense but says a lot about the thought processes behind the choice in words -- a help program seems a lot more charitable than bailout, though at the same time the German word for debt is “Schuld” which translates to English as guilt which is also quite telling.

All of the newspapers are printed daily and were selected based upon the size of their circulation, their perceived political leanings, and the availability of their data on a large scale. The perceived political leanings of the newspapers were an important factor in choosing which newspapers to use as I wanted to ensure that any possible biases within the newspapers would trend away from my hypotheses and thus create a stronger test. For the outsider frame, Adresseavisen is seen as a center-right papers and The Guardian is generally seen as a left-leaning newspaper. For the creditor frame, Die Zeit is also a center-left leaning paper and Le Figaro is a center-right paper. For the debtor frame, El Pais is a center-left paper and Kathimerini is seen as a center-right leaning newspaper. The balance of papers representing leanings of both sides within each frame allows for a stronger test.

Overall, the dataset consists of 4,245 news articles ranging from 2006, the year before the outbreak of the global financial crisis, to July 2015. The number of articles collected by newspaper were limited by the online availability set forth by the individual newspapers. For instance, the

Guardian limits the number of accessible articles online to a set number of pages of results. Additionally, the Kathimerini offers a “relevance” filter which was set at 30% (based upon the article relevance to the key term search). The articles were then broken down and analyzed by newspaper. Of the 4,245 articles, 556 are from Kathimerini, 819 from the Guardian, 931 are from Die Zeit, 645 from Adresseavisen, 849 from El Pais, and the remaining 445 from le Figaro. I undertook a both a quantitative and qualitative analysis of the articles. The quantitative analysis consisted of using supervised machine learning algorithms to first break down the articles by sentence, and then analyze the dominant frames used most often by each newspaper. In doing so, the non-English news articles were first translated from their respective languages into English using the Google Translator API. Translating all of the articles into English prevents several problems, the most important being correlation of articles based on language. After translating the articles into English, I parsed them down by sentence, removed all stop words (commonly used words such as "and" which do not add value to the analysis), and removed all punctuation. This allows for the analysis to focus on the core of the articles.

Grimmer and Stewart (2013) point out several different ways in which text can be used as data, and the methods with which it can be accomplished, I am confident that the one chosen for this research is most appropriate. Following their logic, this paper agrees that "[all] research questions imply different models, or families of models, to be used for analysis, and different methods of validation. Therefore, much of the debate across approaches for automated text analysis is misguided" (pg. 4). Additionally, I use supervised machine learning to train the Random Forrest algorithm as to what each frame looks like within the news articles. This is done by hand-coding the different frames within the newspapers, and then training the algorithms based upon

the hand-coded text. This provides a more valid approach than would that of unsupervised machine learning.

I coded 203 of the articles collected by hand. Of the hand coded articles, each newspaper contained articles from each of the three frames though there was a strong relationship between the frame and the newspaper. The process of hand-coding the text was very straightforward. Upon reading each newspaper article I assigned the article either a “1,” “2,” or a “3” depending upon which frame it fit within. Once these were coded, I tested the validity of my frame classification by creating random samples from the set of hand-coded articles and tested whether or not the computer algorithm classified the articles in the same manner as I had.

In addition to the quantitative approach using text as data, I also take a qualitative approach in analyzing the articles. By reading through the articles, I am able to understand the context from which the frames were taken while also understanding the greater content of the articles. Qualitative text analysis allows for the nuances of the articles to come through more clearly -- the greater stories, trends, and narratives come through which gives me the opportunity to analyze each country's distinct narrative as to what caused the crisis to be told. While the focus of the paper is on the quantitative results, I pull in quotes from the text as anecdotal evidence.

Results

The use of supervised machine learning to classify newspaper frames works in a manner similar to having several people hand-code and cross-validate their results. This is done by hand-coding a smaller selection of the articles, and then implementing the use of multiple algorithms to

find patterns across articles. This provides a more valid approach than would that of unsupervised machine learning. Once the data were collected, and parsed down, the results may be compared to determine how well the algorithms coded the various articles and assigned frames. As Collingwood and Wilkerson (2011) point out, the ensemble approach works to improve the classifier's (the predicting element) accuracy as it relies on multiple algorithms agreeing as to which frame each article falls into. This can be seen in table 2.

Random Forest Test Results	
Samples	203
Predictors	127
Classes	3: 'X1', 'X2', 'X3'
Pre-processing	No
Resampling	Cross-Validated (10 fold)
Summary of sample sizes	183, 182, 184, 182, 183, 182, ...
Resampling Results	
Accuracy	0.8618296
Kappa	0.7928183

Table 2: Test Results from Training Random Forrest Algorithm

Table 2 show us how well the Random Forrest algorithm performed. This shows that the algorithm was 86% accurate in labeling articles based on 10 different iterations of randomly sampling hand-coded texts, training on them, and then testing against already hand-coded text. The sample for which articles to train and test the algorithm was chosen by a random draw within the dataset which is why there is not an equal number of articles within each frame. In total, 203 articles were used to train the algorithm. Random Forest algorithms work by creating multiple

decision trees, each trained on a random subset of features and data points. By combining the predictions of these individual trees, the model aims to improve overall accuracy and reduce the risk of overfitting the training data. Random Forrest algorithms work as an ensemble approach as the model uses a “Bootstrap Aggregation” that relies on taking multiple samples (with replacement) of the training set, which each “tree” being its own unique sample of learning. Within each tree a different random subsample of texts is selected for sampling. Once the sampling is complete, the separate training trees combine into multiple decision trees that are then used to classify the texts. The texts are classified based on a “majority vote” of how the multiple decision trees classify each individual article.

	Greece	Germany	UK	Norway	Spain	France
Debtor	436	170	291	38	769	17
Creditor	57	648	19	133	88	412
Outsider	11	50	457	442	4	0

Table 3: Classification Results by Country/Newspaper

Looking at the results in Table 3, we see how the corpus of articles were classified by the Random Forrest algorithm. I found that 1,721 articles fit within the debtor hypothesis and frame, 1,357 fell within the creditor hypothesis and frame, and 964 within the outsider hypothesis and frame. While not all articles on the financial crisis will follow one of these three frames in an obvious manner, they tend to follow the frames as a whole. One article in Die Zeit claimed “The real enemies of the Greek government do not sit in Brussels or Berlin, but are the financial markets

and its own citizens in Greece.” This discussion of the crisis is one that exemplifies the second frame, that the crisis was not caused by European institutions, or problems stemming from an incomplete EMU, the crisis is seen here as being the creation of the Greek people and financial markets -- presumably implying the capital flight that took place after Greece's problems were revealed. The qualitative analysis of the articles provided further evidence of the frames.

Examples include:

The main problem in Greece is not the debt that runs up. Greece is in a system crisis. The characteristic of such crises is that it takes a long time to see the problems, and it is only the country itself, the inhabitants, and the leaders, who can get the job. A deletion of state debt may be a prerequisite for Greece to get on its legs. But it alone is not enough.

- Norway's Adresseavisen

Shocked by the financial earthquake with epicenter in Wall Street, Europe tries at all costs to defend itself with unprecedented measures on the continent. Though Brussels demanded yesterday that the United States "assume its responsibilities" and pull the world out of this marshmallow, EU governments have been forced to take risky initiatives to protect their economics.

- Spain's el Pais

Table 3 shows us how well the frames align with the six newspapers. As we can see, there is a strong correlation between the classification of newspaper article by newspaper. When hand-coding we see that the frames surrounding the financial crisis exist in all six newspapers. Not all articles within each paper fit neatly into each frame. This is not surprising. Multiple views exist within each country, within each newspaper, and within each in-group. While multiple views exist, it is clear that there is a dominant view within each paper. It is also clear that these views align according to the predicted frames. Newspaper articles from the center right and center left within the creditor frame (represented by France and Germany) predominantly fit into the creditor frame.

Newspaper articles from the center right and center left within the debtor frame (represented by Greece and Spain) predominantly fit into the debtor frame. Newspaper articles from the center left and center right within the outsider frame (represented by the UK and Norway) largely fit into the outsider frame. The outsider countries were more mixed with many of the articles from the Guardian (a center left paper) fitting the debtor frame that blamed the situation, and many of the Adresseavisen (a center right paper) fitting the creditor frame that blamed the disposition of the debtor states.

Even though, as we see in Figure 7, Spain and Ireland suffered from similar ailments (high private debt leading to high public debt) the situations were treated in a distinct manner. Ireland, similar to Spain, suffered from a decrease in competitiveness and productivity when compared to its trading partners while also witnessing increases in labor costs (European Commission, 2011). A pure interest-based account, therefore, would expect Great Britain to respond to the Irish financial crisis in the same manner as the Spanish crisis. However, Great Britain chose to step in and participate in Ireland's bailout but refused to help out other Eurozone states. States in the north such as Germany and Great Britain responded to the crisis in a way that does not represent pure economic interest but in a way that follows a general bias regarding beliefs as to what caused the crisis. Great Britain stepped in to aid Ireland not because Ireland would default on payments to British banks (indeed the Irish bailout would most likely have occurred without British support as did the Greek and Spanish bailouts) but because of an ideological desire and belief that the Irish case is dissimilar to that of those in the south and that Great Britain had a responsibility to act.

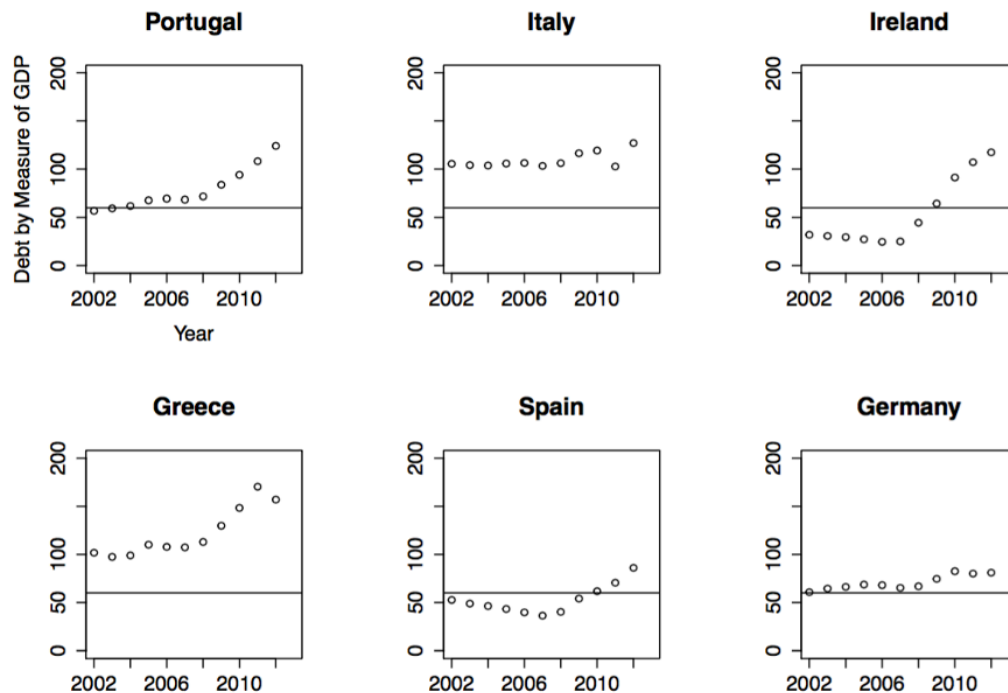


Figure 7: Debt to GDP Ratios for GIIPS Countries

Looking at levels of Foreign Direct Investment (FDI) outflows from the UK, we see increasing levels of FDI flowing into countries such as Greece and Spain while we see negative FDI flows into Ireland in the years leading up to the financial crisis (OECD Statistics, 2016). Additionally, similar levels of exposure for British banks in Spain and Ireland at £55.1 and £77.5bn respectively (25.7% and 29.9% of core tier 1 assets as defined by the Bank of England) (Bank of England, 2012). While banking exposure may be greater in Ireland than in Spain, it is also important to note the vast levels of FDI in Spain. Indeed, here we see the result of a situational rather than a dispositional frame being applied to a northern state. While institutional pressures from bankers, investors, and the business industry would be expected to strongly support a British bailout of both Spain and Ireland, the UK only participated in the Irish bailout. British Chancellor

of the Exchequer George Osborne referred to the Irish as “friends in need”². While Osborne may have couched the argument in terms referring to both British interests and friendship, the figures do not add up as to why the Irish bailout was in British interest and the Spanish bailout was not; according to the UK’s office of trade and investment, 21% (approximately €1.7bn) of FDI in Spain since 1993 has come from the UK (UK Government, 2016). It is clear that Britain's long history with Republic of Ireland played a role in its decision to participate in the bailout, the crisis is seen in situational terms – anyone in the position of Ireland would have been affected by an exogenous crisis in the same way.

Overall, what we see from these results is the prominence of three competing frames along creditor/debtor/outsider lines. Looking at different frames during times of crisis allows us to better understand the level of cooperation we can expect during crisis response, the relative level of contentious politics during and following the crisis, and can allow us to understand what solutions are most likely to be pushed in facing the crisis. The more similar the understanding of the crisis, the more cooperation and deeper integration we can expect at the European level. But as insights from AT suggest, when crises are experienced by groups in different ways, we can expect more contentious politics and the prevalence disposition-based claims being made concerning questions of cause.

Conclusion

The European sovereign debt crisis has largely been a story of austerity measures and bailout programs, but it did not need to be. This chapter has demonstrated the effects of framing

² <http://www.bbc.com/news/uk-politics-11807769>

on crisis response, showing the diverging popular sentiment within prominent newspapers cross nationally. Indeed, there is no single frame that can be used in order to explain any crisis. How crises are felt, experienced, read about, or even studied years later, shapes the ideas held by individuals concerning questions of “cause” and “effect.” This is not to make the claim that there are no absolutes in life, indeed there are. However, absolute claims are hard to come by within the field of social sciences. There will almost always be competing claims and theories as to how the world tends to operate, and even how the world should operate. LIG and NF offer powerful explanations for how the financial crises were responded to. My approach, using SIT and AT acts to bridge a gap. Groups are formed along the lines of identity. Policy preferences stem from how one views the position of their in-group versus how they view the out-group. We have empathy and compassion for our in-group, though that compassion for others ends where the out-group begins.

I have shown that there are three dominant frames concerning the cause of its sovereign debt crisis. The first frame is held by debtor states, that the crisis was caused by exogenous shocks, not their own doing -- a situational claim that does not reflect upon their own character or reputation but the unfortunate spillover from the US financial crisis. The second frame is the creditor frame. The creditor frame holds that the crisis was the fault of profligate states in Europe's periphery who overspent. The creditor frame is a dispositional claim as to the attributes of debtor states. The third frame is held by European states outside of the Eurozone, that the crisis is not the fault of any one state, but the combination of overspending by states and, more importantly, the poor design of the EMU's institutions. The outsider frame sees the crisis as an inevitability, it was bound to happen due to the nature of the monetary union. These competing frames led to tension

amongst leaders as well as stagnant economic growth. This chapter demonstrates that only when frames and beliefs begin to overlap can we expect a convergence in preferences and thus closer cooperation to take place.

Chapter 5: (Dis)Embeddedness and Crisis in the European Monetary Union

*Europe will be forged in crises,
and will be the sum of those solutions adopted for the crises*

*- Jean Monnet
President, European Coal and Steel Community (1952-55)*

Countries deploy a variety of economic and monetary policies during times of financial crises to quell unrest in bond markets, encourage consumer and corporate spending, and instill a sense of calmness amongst people in general. These policies are guided by the economic beliefs held by the government's economic advisors, and those held by powerful central bankers. Economists, however, are not immune from bias or predisposition when making or proposing economic policies. Adolph (2013), for example, shows that the widely held belief that independent central banks lead to better, or perhaps more uniform, macroeconomic policy. Adolph shows that the backgrounds, career concerns/trajectories, and their appointer's political background all work to shape the types of policies put in place by independent central banks. While this chapter does not focus on central bankers per se, it does focus on the policies imposed by the "Troika" of institutions (European Central Bank, European Commission, and the International Monetary Fund) on European Union member states in response to the global financial crisis and the sovereign debt crisis.

I seek to answer one key question in this chapter: what explains the EU's response to the financial and sovereign debt crises? In addressing this question, the answer can be divided into two separate but equally important components, those being the EU's treatment of member states and the EU's treatment of the financial markets. I argue that we have witnessed two different

approaches coming at theoretical odds. On the one hand, the EU created new regulatory institutions with increased competencies to monitor and sanction financial markets which were seen as loose cannons. On the other hand, the EU worked to lessen constraints on state-run social welfare markets in the name of fiscal prudence. SIT and AT work here in showing how groups form, how the groups come to view the actions of others, and how these views shape policy response.

Chapter 4 demonstrated the pervasiveness of stereotypes in the framing of the dueling crises. Countries in Europe's periphery, the GIIPS countries, were framed as being the cause of their problems. This framing allowed for leaders to justify policies that focused on austerity and cuts to social welfare programs in all periphery countries regardless of the underlying causes of the crisis. The banking sector faced new regulations that were both objective (changes to liquidity requirements) and subjective (limits on banker bonuses) in nature. There was a collective understanding that new policies needed to come out of the dueling crises though no consensus on what the policies should look like. Understanding and applying SIT and AT allows us to best understand the nature of the EU's response to the crises as we can see how the rampant stereotypes used to view the actions and position of others, as demonstrated in Chapter 4, came to influence actual policy.

This chapter will first provide an overview of the competing perspectives used to explain the EU's policy response to the crises. Specifically, I will look at how NF and LIG approach the EU's policy response. This section focuses on new financial market regulations, and social policy regulation. NF theory would expect there to be deeper levels of integration in order to protect social interests. While we would expect deeper integration and spillover in the area of social policy, austerity became a powerful tool that was imposed by Germany and the Troika on EU member

states seeking bailouts. Following the discussion on NF, I look at LIG, a first-order rational choice theory on European integration and policy espoused by scholars such as Andrew Moravscik (1993, 1998) and Frank Schimmelfennig (2015, 2018). LIG focuses on member states as the key actors and looks at how the process of integration and cooperation is an efficiency improving process in which actors seek economic gains. It is not a zero-sum game; all actors can be made better off through coordination and cooperation in state-level bargaining. While LIG accurately predicts that German interests would likely prevail due to its position as the economic powerhouse of the EU, it does not account for how Germany arrived at its preference for austerity as a one-size-fits-all response. This leads to the discussion on SIT and AT as coming together to form the best approach for understanding how individuals understand and frame crises, how this framing affects groups formation, and how in-group and out-group dynamics shape policy preferences and policy outcomes.

The next section of the chapter focuses on the policies enacted by the EU and the Troika in response to the financial crisis and the sovereign debt crisis. Here I test the theories by looking at the expectations of the three theories and examining the shortfalls of purely LIG and NF in accounting for the policies enacted. This section is divided into two components. I first focus on the financial crisis and the policies that the EU enacted to further regulate financial markets. These policies included the creation of new regulators such as the European System Risk Board (ESRB), the European System of Financial Supervision (ESFS), the European Banking Authority (EBA), the European Supervisory Framework (ESF), and limits on banker bonuses. The new organizations and regulations represented a strengthening of the supervision of financial markets at the supranational, or European Union, level to allow for a common framework across the EU and to

avoid the patchwork of national level supervision and regulation. The new regulations also marked a departure from regulating financial markets at the macro level to also regulating more normative issues such as how much a banker ought to receive in bonuses. I then focus on the policy response of the EU and the Troika to the sovereign debt crisis. The sovereign debt crisis response was one of across-the-board austerity and cuts to social welfare in addition to new monitoring processes such as the European Semester to impose more stringent financial penalties on member states that do not pass budgets that meet the criteria set forth by the EU and the SGP. Never mind that France and Germany, two core creditor states of the Eurozone, were the first to violate the rules set by the SGP pre-crisis. Regulations enacted in coordination with the bailouts of member states served to regulate member state budgets while also forcing them to implement pro-cyclical policies that undermined their ability to come out of the crisis in a stronger position. The reforms did not allow states to be more able to grow their economies, collect more tax revenue, or indeed pay their debts. They were punitive measures modeled on the prevailing stereotypes and the framing of the crises.

Competing Theories

Neo-Functionalism

NF theory provides a compelling framework for understanding the policy responses to the eurozone debt crisis. This theory emphasizes the role of functional pressures, spillover effects, and the transfer of authority to supranational institutions in driving European integration forward. While the Eurozone has worked to promote economic integration within the EU, the creation of the single market and the common currency in the EU also worked to set the stage for the sovereign debt crisis. NF scholars (Niemann and Ioannou, 2015; Schmitter, 2012) argue that integration in these areas created functional pressures for further integration in related policy fields. When the

crisis hit, the economic instability and the threat to the single currency posed significant challenges that could not be effectively addressed by individual member states acting alone.

According to NF theory, such crises create opportunities for supranational institutions to expand their authority and take on new responsibilities. As the crisis deepened, national governments increasingly recognized the need for collective action at the EU level to restore economic stability and to preserve the single currency. This led to a transfer of power to EU institutions, particularly in the areas of fiscal coordination and economic governance. The European Stability Mechanism (ESM) was established as a permanent bailout fund to provide financial assistance to member states in crisis. The ECB took on a more active role in managing the crisis, implementing unconventional monetary policies and becoming the de facto lender of last resort for the Eurozone. The European Commission's powers were also expanded, particularly in terms of monitoring and enforcing fiscal rules and coordinating economic policies.

NF scholars (e.g. Genschel and Jachtenfuchs, 2017) argue that these institutional responses were driven primarily by the functional imperatives of the crisis, rather than by a grand design or a shared vision of European integration. The self-interest of elites, particularly those with a stake in the stability of the Eurozone, also played a key role in pushing for further integration as a solution to the crisis. Interest groups, such as the financial industry and business associations, also supported further integration as a way to reduce economic uncertainty and protect their investments. The crisis created a sense of urgency that allowed these groups to overcome resistance from those who favored national sovereignty and decentralized decision-making.

While the notion of "embedded liberalism" suggests that market integration is politically sustainable only if accompanied by social protections, NF argue that the crisis responses prioritized economic stability and further integration over social concerns. The austerity measures and structural reforms imposed on crisis-hit countries often entailed significant social costs, but were seen as necessary to restore market confidence and preserve the single currency. In contrast to LIG theory, which emphasizes the role of national governments in driving integration through bargaining and negotiation, NF see supranational institutions and functional spillovers as the key drivers of change. The crisis created a situation in which there was a need for further integration on economic and financial matters, though there was not a clear consensus on what that further integration would look like.

Liberal Intergovernmentalism

LIG, as espoused by Andrew Moravcsik (1993), delves into questions of inter-state bargaining processes and is the dominant theory in the area of European integration. Moravcsik proposes a two-pronged theory that brings together a liberal theory of preference formation and an intergovernmental focus on the power relations of inter-state bargaining. Caporaso (1998: 9) succinctly sums up LIG's core assumptions as "states are rational self-interested actors, they 'read' the demands of society, these demands are somehow aggregated into a preference function for executives, and that these executives negotiate over differences in the international arena." LIG sees state interests as being representative of a variety of domestic interest groups. Not only are states vying to maximize their utility in the international realm, LIG also sees domestic interest groups as in conflict with one another to gain political influence (Moravcsik, 1993). Preferences are fixed until new information arrives and, following the rational choice concept of Bayesian

updating, preferences are reformulated based upon new expected utility maximization calculations. LIG assumes that this updating occurs at critical junctures and are free from a feedback loop. Changes to national preferences stem from exogenous forces. Each juncture is unique and there is no functional spillover to affect preference formation in the current round of intergovernmental negotiations (see Caporaso and Kim 2012; Farrell and Heritier 2005, 2007; Jupille 2004, 2007; Moravscik 1998). EU member states choose to enter into deeper supranational unions due to exogenous factors; these can be financial crises or the collapse of world powers (e.g. fall of the Soviet Union). Schimmelfennig (2015, p. 179) argues that contrary to constructivist or “supranationalist” theories, preferences “are conceived as exogenous to integration. They are neither the result of institutionally induced international learning or socializations processes nor primarily shaped by domestic ideas. Finally, states do not pursue strategic geopolitical interests as assumed by realist intergovernmentalism.”

Following LIG’s emphasis on exogenously derived preferences for European integration and policy we can describe it as a first-order theory within the framework of rational choice. Hooghe and Marks (2019, pp. 1116) point out that within LIG, “The interests that drive decisions on European integration are primarily economic and issue-specific, and aggregation is pluralistic in that government preferences are chiefly the result of interest group, rather than party-political, pressures.” There is no feedback loop within LIG, each time a new treaty or agreement is signed by national leaders it is independent of the one that came before it. LIG’s argument as to why the EU has responded to the crisis follows the debtor – creditor relations story. Creditor states in northern Europe would be interested in pushing austerity on debtor states to ensure that they are paid back as quickly and fully as possible. This can be seen as similar to Rousseau’s game "stag

hunt" in which there are multiple equilibria. On the one hand there is economic cooperation in which all states choose to pursue the stag reaching one equilibria point. On the other hand, there becomes a point at which it is rational to abandon mutual cooperation and chase the hare to ensure one's own survival (the other equilibria point). Though the decision to go from hunting stags to hunting hares is not to say the Eurozone is perceived to be doomed, as Skyrms (2001: 37) points out "... conversely, if everyone is hunting hare and the Huntsman spontaneously switches to hunting stag, in two rounds probably everyone will hunt stag. In the long run the population spends approximately half its time hunting hare and half its time hunting stag." Such an understanding shows how easy it is to fluctuate between different levels of cooperation, but when push comes to shove creditors are interested in getting their money back and pursuing the hare rather than the stag. Thus, the logic of LIG relies on EU member states looking primarily to secure their own national interests. LIG sees institutional outcomes as a function of lowest common denominator politics. States will cede just enough power or authority as necessary to make sure that it is in the interest of the member states to comply.

LIG offers strong arguments to explain the EU's response to the financial and sovereign debt crises; after all, it is the dominant theory employed by those who study European integration. It predicts that national governments will be the key decision makers during the crisis, and that they will seek mutually advantageous bargains. There is a process of "failing forward" in which the EU lurches forward through piecemeal deals rather than more robust ones as member states are often unwilling to accept the comprehensive agreements that are necessary to fully address the problems that underpinned the crisis.

A Behavioral Approach

I argue here that while pressures derive from the supranational level it is through ideational change on the part of member states (and their citizens) that integration occurs. Following the changing relationships within the EU, both between individual member states as well as between member states and institutions, ideas and identities change allowing for further integration. There is a link between crisis and reform throughout the history of the EU. Jean Monnet once said that “Europe will be forged in crises, and will be the sum of those solutions adopted for the crises” (quoted in Hodson & Puetter, 2013: 368). As Wendt (1992) has argued, iterated interaction between states leads to a changed understanding of self, i.e. identity, as well as a changed understanding of other. This leads to an ever-evolving relationship between states in the international system, or in this case, states within the European Union.

As demonstrated in Chapter 4, the sovereign debt crisis was discursively constructed in a manner that promoted divisiveness between member states. Hypothesis 1 focused on how borrowers, those largely within the periphery of Europe, will frame the crisis in situation terms. Such a frame focuses on the role of banks in causing the financial crisis and the sovereign debt crisis. Periphery countries such as Italy or Greece were forced into their situation and any state in such a situation would respond in the same way. Hypothesis 2 focused on how creditors, those in the core of Europe economically, would frame the crisis in terms of disposition. It is the profligate states in the periphery who brought the debt crisis on themselves and the greedy bankers who caused the financial crisis. The creditor frame from the wealthier core states came to become the narrative that shaped the response of the European Union and the International Monetary Fund.

While Germans were perfectly content bailing out German states, or Länder, without tight preconditions, they were not willing to do so for their European cousins.

Both LIG and NF arguments offer compelling, though incomplete, explanations for why the EU and its member states responded to the dueling crises as they did. Neo-Functionalism's argument that the process of Europeanization has transformed beliefs and interests, and creates pressures for policy spillover. NF theory would expect there to be greater cooperation at the supranational level on financial market and social regulations; not greater cooperation on market regulations and austerity measure for member states.

The behavioral approach using SIT and AT provides the conditions under which a European identity will be triggered versus a national identity. The financial crisis was a European crisis. Risk and exposure to the housing crisis and markets knew no borders and the banking industry was no longer nation specific. The EU's mission of creating a European identity with a common currency and supranational institutions created increased pressure for greater cooperation and regulation at the supranational level. This included greater competencies and more regulatory power for the EU. On the other hand, LIG correctly focuses on the role of member states as key actors in the negotiation process who are also wary about giving away too much. We also saw the piecemeal process of bargaining and states as the driving actors in the policy response, though they were not the only actors. Supranational institutions such as the ECB and the intergovernmental organization, the IMF were also key actors in the decision-making process.

The Crisis and Crisis Response

The global financial crisis not only left a devastating financial trail that razed several banks to the ground, the crisis also brought a battery of new regulatory agencies and ideas for how we could avoid such a crisis in the future. New organizations at the European level were created; the ESRB, the EBA, the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA) are all examples of such new organizations. Ideas, too, changed. There was a renewed rhetoric concerning a need for broader financial supervision at the European rather than the member state level. Deeper integration for better coordinated responses was also a key to limiting further systemic risks (See: European Commission, 2005; de Larosière, 2009; Turner, 2009; Warwick Commission, 2009).

Indeed, there was a disagreement as to the level at which a response needed to be made. Academics such as Iain Begg (2009) argued for a quasi-federal response in which more authority is placed at the EU level for supervision. The variances in national supervision were seen as a detriment to the common market. Because member state's financial markets have evolved differently and have come to comprise different percentages of domestic economies meant that they also carried with them varying levels of political weight. With the combination of varying ideas of capitalism, and the varying appetites for risk all while there exists a deep interconnection of investments means there is a higher level of systemic risk should a crisis occur (also see literature on 'varieties of capitalism'). As Begg points out, however, "because of the complexity of the current system, reform is not only about improving regulation, but also about catering to the diversity of national systems" (Begg, 2009: 1114). This section will provide a deeper analysis of

the policies implemented by the EU in response to both the financial crisis and the sovereign debt crisis.

New Financial Regulators

The response at the European level was largely one that integrated deeper coordination at the supranational level while allowing member states to retain a sense of autonomy and individuality. Following the recommendation of the de Larosiere report (2009), the Commission created an agency for the overall macro prudential oversight of the European financial system, that being the ESRB which entered force in 2010 (European Systemic Risk Board, 2013). The ESRB was one of several new supervisory agencies created to mitigate future systemic risks. The ESRB was instituted with the mandate of monitoring the financial system, providing remedial advice, alerting the European Council of any perceived systemic dangers, as well as closely coordinating with other regulatory, oversight, and financial institutions. The European Commission also created the ESMA, which operates under the same framework as the ESRB, that being the ESF and the ESFS. The ESMA works closely with the ESRB, providing it with information from stress tests and other data that it collects.

These institutions marked a movement towards the deeper integration of oversight into the supranational, or EU, level. While the mere existence of these organizations need not signify a further embedding of markets into society, they do signify a further commitment to supervision at the supranational level. The EU went on to create new capital requirements. It was these new requirements that served as constraints on market processes at the behest of European institutions

in the name of prudential supervision. Capital liquidity requirements changed the amount of money that banks needed to keep on hand relative to the money they lent out.

In its impact assessment of a new directive concerning the supervision of various financial industries (e.g. banking, credit, insurance), the European Commission remarked that “[in] some Member States the levels of pecuniary sanctions (fines) are too low and thus insufficiently deterrent; and sanctions cannot be imposed on both credit institutions and individuals responsible for violations” (European Commission, 2011: 2). This discussion emphasized the need for not just new regulations, but also a stricter system to deter institutions from violating the requirements. The European Commission document additionally outlined the need for a clearer corporate governance framework and to further engage boards in key decision-making along with executive management. The European Commission recommended that new benchmarks be installed along with supervisors to develop new corporate governance structures allowing for a more effective management of risk by corporate boards (European Commission, 2011: 6). Of importance here is the recommendation to transfer a level of authority from those who manage a financial institution to the board members who provide guidance.

Basel III and New EU Financial Requirements

20 June 2013 the European Council adopted the Basel III banking reform, mandating that the EBA monitor “the quality of instruments issued by institutions” (Council, 2013b). This new directive by the European Council created new capital, liquidity, leverage, and corporate governance requirements that took effect 1 January 2014. Amongst these new requirements was an increase of the liquidity coverage ratio (LCR), eventually to 100% from 2018, also limiting

liquidity inflows to 75% of liquidity outflows to prevent undue reliance on outside sources of liquidity to meet outflows (2). As an answer to macro-prudential supervision, an increased competency was given to member states, enabling them to impose strict requirements on domestic institutions for limited periods of time. There was also an introduction of a cap of banker bonuses at a ratio of 1:1, bonus to fixed salary, less a qualified vote of shareholders agrees to a higher bonus (4).

The EBA managed the implementation of the new capital requirements following Basel III. The EU directives covered not only capital requirements but also the prudential requirements for investment firms and financial institutions (European Banking Authority, 2013). Some of the new requirements included an increase in the quality and quantity of capital to be held by banks as a means of ensuring a more “resilient” banking sector (Bank for International Settlements, 2011). Additionally of relevance is the “constrain[ing of] leverage in the banking sector,” this constraining was a mechanism to mitigate future risks that may stem from a process of “destabilizing deleveraging processes” that may occur during a future crisis (Ibid: 12).

It is not the mere act of regulating such institutions that served to further embed them in society, but also the discourse that surrounded them. The discourse surrounding the crisis informed us of the cause and solution, regardless of their accuracy or indeed efficacy. In the case of the 2007/2008 financial crisis in the US, the route of the problem was accurately traced back to the US housing collapse, and more importantly to the unsound system of finance that allowed such a housing-bubble to inflate (Acharya & Richardson, 2009). The sub-prime mortgages that were offered and sold to investors in bundles alongside the so-called ‘good’ mortgages were seen as a

hedge against the chance of sub-prime defaults. Through credit default swaps and other new financial instruments, it was thought that risks of default would be mitigated on the whole by the safer investments in “higher quality” mortgages. Unfortunately, as Blyth (2013a) points out, the mathematical models used to predict risk failed. The systems portrayed the future as a normally distributed replication of the past; “the risk is in the tale, not the middle of the distribution, and it’s massive” (Blyth, 2013a: 37).

The EU responded to this crisis in a manner that further constrained market processes. Through the institutionalization of financial and banking regulations at the supranational level, new constraints were placed upon not just the capital or liquidity requirements of the financial industry, but also on their form of corporate governance. The behavioral approach will note these new caps on bankers bonuses. While some much-needed regulatory reforms were brought in, so too were the popular reforms of regulating such things as bankers’ bonuses. The reforms to the banking sector did not stem from an overall economic imperative but from the political benefits stemming from the framing surrounding banking practices and the need to “rein in” the “risk-taking bankers.” No more massive bonuses for those who profited from others’ losses. Groups such as the “Occupy” movement built their base from people disenchanted with not so much the technicalities of regulation, but the “egregious” nature of who profits and who loses, seeing it all as a zero-sum game.

The behavioral approach accounts for the new subjective and objective regulations. The behavioral approach looks at the power of the narrative of how the crisis was constructed and at the process of socialization in creating pressures for deeper integration and competencies at the

EU level. The more normative policies that included caps on bankers' bonuses are also not surprising. Behavioral approaches look at the European Economic and Monetary Union and the Schengen Area as a weak regulatory structure, which would demand a European response. The in-group and out-group identity formation came down at the European, rather than national, level. The financial crisis treated everyone the same. National regulations for banks without borders did not work. LIG may also account for the greater level of supervision at the EU level, it does not explain the normative policies invoked by the EU. If national governments are responding to domestic economic interest groups, why would these groups demand limits on banker bonuses as part of the new regulatory framework? The dominant domestic economic interest groups in Berlin, The Hague, London, and Stockholm were not the Occupy Movement. LIG acknowledges that party-political interests are overshadowed by economic interest groups.

Austerity and the EU's Contrasting Approach for Member States

The new policies enacted to regulate member state budgets following the sovereign debt crisis came at a contrast to how new regulations concerning financial markets were brought in. Having framed the financial crisis through a lens of imprudent financial decision-making on the behalf of private actors, it should come as a surprise that member states were seemingly the ones being punished most harshly. While this may be a subjective statement, its relevance remains. We must ask ourselves: if member states faced their problems because of a collapse in tax receipts and a rise in welfare spending due to counter-cyclical measures such as unemployment insurance costs (Greece being the outlier), then why is it that they were framed as the drivers of their own woes? This is not a very easy question to answer; yet we may broadly state that it has to do with the economic paradigm with which decision-makers and the public were informed. This was discussed

earlier in the previous chapter. On the one hand, we have creditor states who view the crisis in terms of disposition, the profligate south overborrowed and spent their way into crisis. This narrative sets decision-makers under a paradigm of neo-liberal economics in which they see balanced budget measures and austerity rather than growth measures as the key to improving the economy. On the other hand, we see the debtor states who view the crisis in terms of situation, they were forced into their situation because of the actions of the greedy banks.

Problems in the Eurozone and New Forms of Supervision

The EU instituted the “European Semester of Economic Policy Coordination” as one of its cornerstone, new methods for budgetary supervision. The European Semester was created to foster deeper discussions amongst member states at the European/supranational level concerning budgetary measures before they are made at the national level. This was intended to lead to better coordination of budgetary and structural reforms, and to create a more in sync agenda wherein policy recommendations and reforms would be handed down by the European Commission in a country-specific format (European Commission, 2011). This was enacted following what was perceived as a failure of the SGP. The SGP monitored budgetary deficits in a weak and uncoordinated manner without any repercussions for failure to abide by SGP regulations. Member states did not face the preventative measures the EU had set in place (Ibid). Even France and Germany failed to stay under the 3% deficit-GDP ratio pre-crisis, setting a precedent for non-enforcement (McGiffen, 2011: 38; Buti & Carnot, 2012: 900; European Commission, 2012). France and Germany’s violation of the very regulations they created to regulate periphery states came to be known as the “original sin.”

Armed with new methods for combating excessive debts and deficits, the European Council granted further authority to the European Commission and ECB for penalizing member states. Via the two-pack, six-pack, and the European Semester, we saw a transformation of the SGP and a strengthening of European institutions while also strengthening market processes. Given that the ECB does not have a mandate to finance the operating budget of member states, it was not able to purchase government debt (though it does now). Instead, member states were required to sell their bonds on the competitive private markets (Drudi et al, 2012: 893). This was done in an effort to limit inflationary pressures within the Eurozone as the ECB was not able to print Euros in times of member state budgetary shortfalls as national central banks had done in the past. Drudi et al recognize several inconsistencies within the Eurozone leading up to the crisis, only serving to exacerbate the results (894). It was the combination of strict budgetary guidelines via the SGP, the inability of member states to print money or devalue their currency in times of need, and uncertainty concerning their ability to cover their debt obligations that really brought about the sovereign debt crisis. It was this institutional lock established by the nature of Maastricht and the ECB that led to austerity and the power of bond markets to turn solvent states insolvent.

Steve McGiffen (2011) points out that while SGP regulations are applicable to all EU member states, the corrective arm may only be utilized in cases where Eurozone countries fail to meet the regulations. The sanction is 0.2% of the member state's GDP placed into a non-interest-bearing account. This would be repatriated to the member state should it follow EU guidelines to restore fiscal and budgetary prudence (Ibid). If the member state fails to satisfy EU requirements the fine is to be kept, and possibly repeated – the amount of the fine is on a sliding scale up to 0.5% of the member state's GDP (Ibid). Unlike under previous arrangements, the new sanctioning

regime is to be more easily applied to ensure fiscal prudence through a new system called Reverse Qualified Majority Voting (RQMV). RQMV works by allowing a qualified majority vote to reject a Commission proposal by the Council (European Commission, 2013).

This regime of balanced budgets comes under the auspices of a neo-liberal agenda through which monetarist economists stress the importance of limiting inflation – occasionally at the expense of deflation. Blyth (2013: 118) traces the idea of austerity back to the Austrian economists of the twentieth century. Today these ideas come most fervently within the Eurozone from Germany, where the history of hyperinflation during the interwar years and the ensuing rise of political extremism remain in the minds of many. What in Germany the “Ordoliberals,” or the “order liberals,” see as the role of government is its position as framing the conditions necessary for a functioning market. It is a “rule setter that enables competition and aids market adjustments through the development of specific economy-wide mechanisms and institutions” (Blyth, 2013: 133).

High Debt, Public or Private? Cut Budgetary Spending!

Many tend to apply the unique case of Greece as the archetypical foundation for problems faced by all struggling EU member states. This is problematic in that differences in cause are lost in finding a singular solution. Indeed, the EU sought to dis-embed state markets from society via its austerity measures. This is evident in the White Paper (European Commission, 2005: 8) where, in 2005, the EU announced a need for the “public sector to gradually withdraw from financing some aspects of social systems.” The statement is relevant regardless of it taking place before the Eurozone crisis occurred due to the path dependent nature of European institutions. We see the

desire for furthering economic and market integration within the EU, the crisis only served to be fertile ground for the EU to further integrate financial markets while dis-embedding and cutting social markets via fiscal austerity in the name of balanced budgets. Former Chief of Staff for U.S. President Barack Obama, Rahm Emanuel, once remarked “you never want to let a serious crisis go to waste. This crisis provides the opportunity for us to do things that you could not do before” (quoted in Seib, 2008).

As a result of the push for balanced budgets, member states that received bailouts by the EU and IMF faced strict conditionality concerning the funds they received. Funds transferred from the EFSF, in the form of a “bailout,” were directed to a member state – thus in the case of the Spanish bailout, in order for the much-needed recapitalization of the Spanish banking sector, the Spanish government was required to act as an intermediary between the banks and the ECB. The Spanish government took the loan, totaling up to EUR 100bn, onto its own books. This is very apparent when looking at Spanish debt-GDP ratios (European Commission, 2014). After fear spread that some states would be unable to meet their obligations, their ability to raise further funds dried up. Germany, France, the IMF and the EU then created a bailout program. As a condition of funding, member states were required to make cuts to their budgets, reduce the size of their workforce, and streamline regulations as a means of aiding national businesses.

Greece and Spain were treated as the same when it came to receiving bailout funds, though the two members of the Eurozone had very different economic outlooks. Greece is the true outlier when considering problems faced by Eurozone countries, yet it is one of the most well-known of the cases. Largely speaking, the idea of profligate government spending and a bloated government

workforce applies to the Greek case, which is uniquely Greek. In 2007, Greek public debt was at 107% of its GDP with a budget deficit of 6.5%. The same year Spain had a debt-GDP ratio of 36.3% and was running a budgetary surplus of 2% (Eurostat, 2013a; Eurostat, 2013b). While other member states have received similar funding programs, none of them were brought into their problems solely based upon their own poor financial management. Some of the other problems ranged from a collapsed housing sector in Ireland, bank runs in Cyprus, and insolvent banks in Spain.

Spain is a truly interesting case to explore. The Spanish government received approval for up to 100bn Euros to recapitalize its desperate banking sector (European Stability Mechanism, 2013). The financial assistance was paid to the Spanish government's recapitalizing fund (Fondo de Reestructuración Ordenado Bancaria), which in turn provided various financial institutions with liquidity. What makes the Spanish case interesting is not the fact that it has received a bailout from the ESM, but how limited Spanish debt was as a ratio to its GDP. Spanish debt remained below 70% even in 2012 (Fishman, 2012). In fact, up until the start of the financial crisis, the Spanish government had been running an annual surplus. It was not until the Spanish housing market collapsed and eventually required a recapitalization program that the Spanish government had problems (Ibid; Caporaso & Kim, 2012; Kennedy, 2011). Spain, though, faced the same pressures to cut its budget as member states such as Greece whose problems trace to back to overspending.

Greece, unlike Spain, suffered from very high levels of public debt. By September 2013 Greek public debt stood at approximately 180% of its GDP, (a GDP that had contracted 20% from 2008) unemployment at around 26%, and a decrease in the working population's salaries of about

40-50% since 2008. It came as no surprise that Greece faced dire problems (Fouskas, 2013). Greece accumulated a large number of civil servants while being unable to develop a large-scale industrial capacity. Since the 1970s, the Greek government had to borrow, both domestically and internationally, in order to finance its growing public sector – with a debt-GDP ratio climbing from 20% in 1975 to 120% in 2008 (Ibid; Matsaganis, 2012). Rather than receiving a bailout to finance bank recapitalization like Spain, the Greek government received multiple payments from two “economic adjustment programs” financed by other member states and the IMF via the EFSF.

Greece received over 130bn Euros in funding from the EFSF under strict conditionality that cut the size of its budget and workforce as a means of reducing its debt (European Financial Stability Facility, 2013). The Greek bailout came with much more than an austere budget, it also came along with a “haircut” for holders of Greek sovereign debt and labor reform. The IMF and EU believed that by making large cuts upfront, cutting debt to bondholders, and easing labor requirements, that in the long run the Greek economy would benefit (Rogers & Vasilopoulou, 2012). To avoid Greek default, such arrangements were made.

Of importance, however, is not an in-depth discussion on Greek budget cuts, but the reliance of the EU on austerity as the reaction to an economic crisis. In the cases of Spain and Greece we saw the same “medicine” prescribed for very different ailments. Be it private debt problems, or an overly indebted government, the EU saw austerity as the key for improving one’s economy. In essence, there is a reliance on neo-liberal economic policy – the idea that, like its citizens, the government cannot spend beyond its means and must make cuts when its revenues fall. As a result, there is a dis-embedding of state-run markets from society as a whole. There is a

net reduction in welfare benefits provided by states and a further liberalization of labor and other means to promote growth within the private sector.

The EU focused on austerity and liberalization as the remedy *de jure*. Objectively, measures of austerity are meant to tear down walls that may have hindered the operation of efficient markets – an ideological view contrary to that of embedded liberalism. While the mere cutting of a national budget need not be the only solution to a financial crisis, we do see that that the only solution applied, regardless of the reason behind the crisis, was austerity. In the case of the sovereign debt crisis the idea that the size of the state must be cut, regardless of the problems causing the individual crises, came as the only acceptable solution. While the Irish and Spanish bailouts were due to banking shortfalls, rather than issues with government spending, they were required to make cuts to domestic welfare. Germany, too, faced issues with domestic banks. The German government announced €500bn worth of “rescue money” through direct capitalization and guarantees for its own domestic banks to ensure confidence in 2009. Rather than implementing austerity at home, Germany was able to provide domestic bailouts free from the same conditions the Troika and Germany placed upon others.

Fears of potential contagion came to dominate the discourse and fueled the fires making it impossible for countries outside of the periphery to borrow money on bond markets. Yields on German bonds fell while yields on peripheral country bonds skyrocketed. Pricing was not based upon the insolvency of banks but on the narratives of who was at fault and who was not. That German domestic institutions and banks were part of the in-group meant that they were not part of the problem. They were victims of the problem.

The Shortfalls of NF and LIG Theories

LIG and NF offer important explanations as to why the process of European integration has proceeded as it has. LIG tells a story of dominant national governments guided by preferences exogenous to the EU and free from the feedback EU institutions and processes bring with them. LIG theorists do not acknowledge how structural economic shifts at the European level may bring structural economic shifts at the domestic level that may allow for a changing of interests at the national level (Kleine and Pollack, 2018). While LIG correctly forecasts the role of national governments in helping to shape the response of the EU and the Troika to the crises, it does not account for the role of EU institutions, the Europeanization of identity, and path dependency in also playing integral roles in shaping the response to the crises. Of course, national governments are important actors in shaping the policies, but so too are the public and the framing of the crises.

NF offers important insights into why the response to the financial crisis consisted of greater regulations for the financial sector, both positive and normative ones. NF has a more difficult time making clear arguments as to why austerity was the main tool utilized in responding to the sovereign debt crisis. The austerity measures undermined state welfare structures and workers' benefits. A NF response would include an easing of SGP regulations, the creation of Eurobonds, as well as the establishment of a fiscal union. This would allow member states to finance temporary increases in debt more easily following the use of counter-cyclical mechanisms to prevent deeper economic woes. In short, a Polanyian framework would expect to see growth measures rather than austerity. Instead, we saw a focus on "stability" and the need to mitigate systemic risks stem not from financial institutions but from an avoidance, and when necessary, a

cut of sovereign debts, leading to all “profligate states” curtailing spending at the same time, only to further hamper a weak economy (Blyth, 2013b: 222). Where we see a furthering of EU regulations and policy spillover for financial markets, we see a retreat of the EU when it comes to social market regulation.

Focusing on how in-groups formed along the lines on national identity when looking at national budgets and welfare, and along the lines of a supranational identity when looking at financial markets offers the most comprehensive view on the responses to the dueling crises. The in-group and out-group dichotomy demonstrates how people describe the actions of compatriots and members of the out-group. This group formation is dependent upon processes of socialization, institutionalization, and framing. The EU’s Economic and Monetary Union was built upon the Europeanization of financial markets, not social welfare or budgets. The nature of the EU as a sui generis entity has allowed for national and European identities to flourish in ways that both strengthen and undermine the European project. Individual state identities and concepts of self-interest rather than supranational concepts of identity can take hold depending on the issue(s) at hand. By this I mean, how crises are framed (either at the state or supranational level) will evoke very different calculations. When states are part of a common monetary union their calculations are more likely to be focused upon the supranational level as their individual fates are closely intertwined. Furthermore, how states and their public experience a crisis will shape belief systems as to the appropriate response.

Conclusion

This chapter has shown the vast distinction between the response of the EU towards the regulations constraining financial markets and those constraining member state budgets. I have laid out a theoretical understanding of how to interpret an economic and financial response in a time of crisis, focusing on its effects concerning the relationship between markets and society and between the different identities the crises can induce. While NF scholars may expect to see a further entrenching of both private financial markets and social welfare markets deeper into society to mitigate the occurrence of future crises only the former has come to fruition. LIG would then expect the new supranational financial market regulatory structure because it was in the interest of the dominant member states, not because of a functional need stemming from path dependency. LIG theorists also say the response to the sovereign debt crisis and the push for austerity came from domestic interest groups and their pressure for the dominant member states to extract repayment of private and state loans even though austerity undermined the ability of the states who received bailouts to collect the tax receipts necessary to repay the very loans given.

Financial markets have come under the scrutiny of both public and private organizations and peoples. The result of such scrutiny, as we have seen, is more strict regulations concerning the operations of financial institutions through the institutionalization of financial oversight processes at the supra-national, rather than national level. Such new regulations concern themselves with not just the technical requirements concerning liquidity requirements but also the more normative limits on bankers' bonuses and the relationship between the boards and the executives running the firms. The inclusion of such normative regulations concerning how corporate governance should operate, and the placing of power more deeply in the hands of the board and stockholders, helps

us to understand the ideational construction. We have seen that the focus on both technical and normative changes have come about following how decision makers and the public have been informed concerning their ideas as to how the crisis came to be. For many, the fact that bankers received bonuses at times where they performed poorly was an outrage – politicians had to seize the political opportunity to regulate the industry both technically and normatively. The result as laid out was a deeper embedding of financial markets into society. A further constraining of markets by European institutions came as a means to socially protect market participants from market actors and crises.

Member states and their budgets received very different treatment than the financial markets. European institutions constrained member states' abilities to use growth measures as a means of reviving their economies. This, of course, is traced to the institutional construction of the EMU, that states have two options when bond markets vacate, deflate or default. A one-size-fits-all approach had been deemed fit. The continued use of neo-liberal economic policy came at the expense of the public workforce and social spending. Member states were forced to make budget cuts in order to receive much needed EU funds to either bailout their own government or the private sector. This mandatory austerity came regardless of the level of national debt. While member states were constrained, their reforms to labor markets and domestic regulations led, at the behest of the EU, to an easing of efficiency for private markets. Therefore, an opposite effect to what has transpired directly at the regulatory level for financial markets.

We have seen a stark difference in the ideational composition of reforms for both financial markets and member states. The construction of the greedy banker paradigm has led to the industry

facing new normative regulations in addition to a furthering of technical requirements and regulations resulting in an embedding of the financial markets even deeper into society, thus constraining the markets. The construction of the sovereign debt crisis paradigm as one of excess, government profligacy, and large unsustainable welfare inefficiencies has been addressed with strict austerity measures as a condition of receiving economic assistance.

Chapter 6: Conclusion

Most people are other people. Their thoughts are someone else's opinions,
their lives a mimicry, their passions a quotation

- Oscar Wilde

Financial crises represent both times of unease and times of progress. Financial crises represent unease in that they involve large amounts of human pain and suffering. Families lose their homes, people go unfed, and hysteria often plays an oversized role in public discourse. Financial crises also represent times of progress. Crises allow for that critical juncture that is often necessary for realigning institutions to better serve the public. Crises can also be periods in which institutions and public policy are realigned in a way that takes away from the public good. Understanding the role of empathy and identity in preference formation provides us with a clear view of how individuals see themselves in relation to those around them, and it allows us to better understand the logic behind their decision-making.

The 2007-2008 global financial crisis was a critical juncture for the EU. The fragile EMU and its common market was shaken to its core. The common currency and market that allowed for the easing of trade barriers, greater efficiencies, and lower bond yields brought with it a straitjacket that all but eliminated the ability of governments to act independently in their response to the crisis. The crisis response was one marked by austerity for those in the periphery and greater regulations for financial markets. The information asymmetries surrounding financial crises make it difficult for well-balanced responses, and the union of countries in a common currency and market without a fiscal or banking union made things even more difficult. The dissertation focused on the

questions of how do preferences form in times of crisis and how do these preferences affect policy outcomes?

Rational choice arguments, such as that of LIG focus on the interests of individual states. States are often egocentric in that they are looking to maximize their own narrow self-interest in their quest for greater economic gains. Many classical liberal and libertarian economists see this as the cornerstone of a free market economy. If each of us are to pursue our own interests and engage in trade, we will find that all of our needs are met. We of course do not live in such a society, we live in a society that is based on both a free market system and one that is governed by the rule of law. Rather than having a mysterious invisible hand that manages the marketplace, we have private enterprise working within a framework of government oversight. This framework, however, can fail and crisis can strike.

In this dissertation I put forward a behavioral theory of preference formation in political economy. Chapter 2 argues that SIT and AT shape how individuals form groups in line with the identity triggered by the crisis. The more salient the identity, the more likely it is to be triggered when a crisis occurs. As we form in-groups based upon the triggered identity, we rely on beliefs, heuristics, and biases in forming opinions about the out-groups. Crises are already inherently turbulent times, knowing that groups will not accept the positive attributes of others creates difficulties when trying to form a policy response that is effective. As a theory chapter, Chapter 2 brings in an important understanding of empathy and identity. Empathy and identity work hand in hand in shaping the care and compassion, and the fear and derision we may have for others. Understanding the power of emotions and the ways in which we form groups gives us more insight

into how we form preferences in times of plenty and in times of peril. We act out of kindness for those we identify with, we have compassion for those whose position we can understand. There is a limit to this caring and compassion. We do not always act this way when it comes to members of the outgroup.

Chapter 3 focuses on preferences for free trade with data ranging from 2005 to 2019, showing how free trade preferences changed in the wake of the crisis. Neither LIG nor NF theories adequately explain the changes in openness to free trade. While there is a general movement against free trade that both theories can explain, they do not sufficiently explain the other factors. The behavioral approach provides the most comprehensive explanation looking at the sharp decline in trade openness, and the divergent rates at which each country recovered, and preferences shifted back toward trade openness. By 2019, preferences for free trade openness had not yet returned to pre-crisis levels.

Chapter 4 focuses on AT and the role of framing during the sovereign debt crisis. I demonstrated the competing frames that within creditor, debtor, and outsider states. The competing frames stem in-group and out-group formation. AT provides us with strong predictions as to how crises will be framed based on situational versus dispositional terms. Chapter 5 builds on the argument in chapter 4, demonstrating the effects of the competing ideologies and framing on actual policy. Chapter 5 shows that as the EU acted to further embed financial markets into society through further regulation. While the EU created further regulations on financial markets it was actively working to dis-embed state-run social welfare markets from society through mandatory austerity. Here I compare the behavioral approach to the dominate two theories in European

integration in explaining the actual policies that the EU, the European Central Bank, and the International Monetary Fund put in place. LIG and Neo-Functionalism are powerful, but the behavioral approach offers a more nuanced understanding for how policy preferences formed.

This dissertation is the first step on my part in developing a behavioral theory in political economy that pays attention to the role of emotions and identity. Emotions need not be a bad word in the realm of political economy. Economists have long embraced, and earned Nobel Memorial Prizes, for their work in behavioral economics. It is time that the field of Political Economy, and International Political Economy in particular, to pay more attention. The goal of this dissertation is not to say everyone else is wrong, or that LIG or NF are not useful. That just would not be true. My goal is to show the power of emotions in shaping our views of others and putting forward a behavioral theory of preference formation that should play a more important role in PE and IPE discussions. Emotions are powerful and they form a central part of our being as individuals, and they shape our views of others for better or for worse. They are not perfectly rational, nor are they irrational.

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