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# EMU and the Process of European Integration: Southern Europe's Economic Challenges and the Need for Revisiting EMU's Institutional Framework

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### Abstract

The EU has been experiencing over the last few years an unprecedented crisis that really touches on its core characteristics and values. The EMU project was structured on political foundations and expectations, bearing, however, immense socio-economic impact. The main aims of this paper is to identify the main driving forces that influence the future development of the Economic and Monetary Union and to examine the present situation that the EU faces, the priorities of the ECB and the challenges that EU's Southern member-states face.

Moreover, the paper contemplates four realistic scenarios of the future development of the EMU and how each one of them may influence EU's final destination and EMU's Institutional Framework.

Finally, the paper takes note of the challenges that the EU will face in the immediate future both on the institutional/political level as well on the core-periphery relations level.

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### 2.1 EU: A History of Pursuing Political Goals Through Economic Integration

Since the end of WWII Western Europe has been characterized, conditioned and shaped by the emergence of a pioneering project, that of regional integration. As M. Cini has accurately pointed out "...there is no historical precedent for the creation of a multinational, multicultural, and multilingual federation of states

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with mature social, economic, political and legal systems. In this regard the EU is a colossal and original enterprise.”<sup>1</sup> One could trace many incentives, depending on the level of analysis (individual, state, international) he/she applies, for the development of an entity that started as an international organization of pooling resources and has resulted to being an international actor with state-like attributes. Still, even though the break out of the Cold War may explain a great deal about the historical roots of the EU,<sup>2</sup> the initial drive behind the idea of European integration remains that of overcoming once and for all the animosities that existed between the relations of major European powers and tantalized the European continent for more than 50 years (since 1870 that signposts a fundamental restructuring of balance of powers in Europe), if not for centuries.

First and foremost, European integration comprises the most successful peace project in history leading to the longest period of peaceful coexistence between leading European powers (60 years). The EU has resulted to a *Pax Europaea* managing to abolish the idea of war between its member states as the means of solving inter-state problems and promoting cooperation and joint management. Indeed, the EU represents an answer to the perennial question of European unification. This goal was repeatedly pursued in the past through the use of force or by projection and imposition of a certain ideology over other nations (Roman Empire, Carolignian Dynasty, Holy Roman Empire, Habsburg Monarchy, Napoleonic France, National-socialist Germany). The EU stands as a watershed to this legacy of violence championing sharing sovereignty and joint management of capitalist economies.<sup>3</sup> It comprises a formative influence on economic, political, social, cultural, technological and environmental developments that since 1950s has fostered the revival and transformation of European economies and societies, the extension and reinforcement of democratic government and the rule of law and the attainment of unprecedented general level of economic prosperity in European history. This achievement was realized through a painstaking progress, applying a careful incremental approach to the expansion of EU competencies, many times by performing a qualitative leap forward for breaking the mould and lifting a deadlock.

There are not few those cases in EU's history that a potential deadlock gave the impetus for brave decision making opening the path to EU's further integration. Even from its inception, the EU has demonstrated this “leap forward” culture championing economic cooperation in order to surmount political problems. The Treaty of Paris (1951) and the establishment of the European Coal and Steel Community (E.C.S.C) may be seen under this light. The new entity aimed to put under common European control the coal and steel mines of Ruhr and Saar region. The core idea was to establish a common market on those raw materials that are

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<sup>1</sup> Cini (2003), p. 73

<sup>2</sup> European Union (EU) that succeeded the European Communities and thus this term is used rather than its previous titles as Common Market, European Economic Community (EEC) or European Community (EC).

<sup>3</sup> Tsoukalis (2003), Ch. 1.

fundamental for waging war and to setup European supranational institutions promoting shared sovereignty.

As the fear of German aggression remained in Western European countries and the rise of the Cold War increased US pressures on Britain and France for Germany's rearmament, the proposal for the establishment of a European Defense Community was put forward, in order to put new German troops under European control. However, the idea of sharing sovereignty on such a sensitive field as national defense, that touches the core of the nation-state, resulted in the rejection of this plan, oddly enough, by those who proposed it in the first place, the French side. In fear of watching the infant project of European cooperation falling apart, the Treaty of Rome (1957) and the establishment of the European Communities was advanced, which was restricted to vague references to political cooperation focusing more on the field of economic cooperation.

The history of the EU is fraught with similar examples of failure of political cooperation and redemption through the advancement of further economic cooperation, the two most important being:

- The clash (1965) between France and other member states on the supranational or intergovernmental nature of the EU that had as a consequence the withdrawal of France from EU institutions for 9 months (empty chair crisis) and the Luxembourg Compromise, later on, resulting in the Merger Treaty of Brussels (1967) and merging the European Communities into a single institutional structure.
- The rather unsuccessful fate of the Fouchet Proposals (1970s-European Political Cooperation) that resulted in the acceleration of the Single Market.<sup>4</sup>

EU's historical development stands as an unquestionable testament to its political nature and its initial *raison d'être*. Whenever Europeans reached a dead end in the field of political cooperation they resorted to further cooperation and coordination on economy, trade and secondary fields of state policies anticipating that the development of supranational institutional bonds and interests would bend hard core sovereignty interests converging 1 day to a political union. Hence, the integration process has not always been smooth and economically or politically costless. Yet, it has brought the European continent in the eve of a post-modern era that bears both gains and challenges; on the one hand, war between EU member states has become quite unthinkable but on the other hand EU nation states are called to surrender more and more layers of their sovereignty if they want to steer the boat in the harbor of enhanced integration and some kind of federalism.

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<sup>4</sup>Tsakaloyannis (2000).

## 2.2 Theorizing the EU and Its Policies: Deepening, Enlarging and the Changing Nature of the EU

The EU's incremental approach is incarnated best in its major treaties. The mid 1980s and early 1990s signposted the revival of the EU, as it took the leap forward for the realization of the Single Market and the establishment of the Economic and Monetary Union (EMU). The EU accelerated further integration through a number of treaties such as the Single European Act (1986) and the treaties of Maastricht (1992), Amsterdam (1997) and Nice (2001). Those Treaties expanded EU competencies over a number of policy areas that shaped the *acquis communautaire*, whilst EU law increasingly took precedence over that of member states. While the EU deepening process was launched, it was accompanied, at the same period, by EU's membership expansion. Over the last 20 years the EU family has reached the number of 28 member states from 15 in early 1990s. The impact of those two parallel processes on the EU's functionality and operations was an issue that was puzzling every interested party, from EU officials to academics.

Several theoretical concepts over the EU's future *modus vivendi* have emerged over the span of time. Prominent figures such as Winston Churchill and Richard Nikolaus von Coudenhove-Kalergi had articulated the notion of a united Europe as early as the 1930s–1940s. On the theoretical front, economic thinkers such as Friedrich Von Hayek and Jean Monnet influenced fundamentally the conceptualization of European integration process. The former was immensely concerned over the solution of the “German Problem” advocating the advancement of a political market-based union that would result in the development of functions to a regional or local level, thus delineating the liberal integration project.<sup>5</sup> The latter is considered to be the founding father of supranationalism. From an economic standpoint, his main focus was to promote deconcentration and decartelization. He showed no great confidence to the unregulated free market, placing his faith in supranational institutions and common economic policies. Jean Monnet's pivotal contribution to the European project was his notion of an international form of organization that would be robust, capable of reaching agreement by means of compromise and consensus. Monnet claimed that such an entity would foster economic cooperation and such levels of interdependent relations that would eventually lead to political federation and secure peace (functional federalism).<sup>6</sup>

Both these theoretical concepts served as points of reference to the development of integration theories that followed and enriched the perception of the state in the international system. Federalism and Functionalism proposed the containment of the nation-state, while Transactionalism sought to theorize the conditions for the stabilization of the nation-state system. In view of further enlargements and deeper cooperation, integration theories evolved into new theoretical schemes. The two competing theories that dominated the debate over EU integration were

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<sup>5</sup> Gillingham (2003), Ch. 1.

<sup>6</sup> Rosamond (2000), Ch. 1, Gillingham (2003), Ch. 2, Monnet (1962), pp. 203–211.

Neofunctionalism (Lindberg 1963) and Intergovernmentalism (Hoffman 1964, 1966) while Constructivism came to enrich the debate.<sup>7</sup> (See Annex 1).

As much as this debate dominated not only the theoretical realm but also the structure of EU policies and every day practice, contemporary developments within the EU and the international environment rendered the aforementioned duality somewhat outdated. So, while before 1992 the focus was on the *form of integration*, on the normative practices of EU institutions (henceforth, “euro-polity”) as an *dependent variable* and on the *reasons that integration occurs*, the 2000s surfaced a new perspective on European integration focusing more on the *spill-over effects that it has*, on Euro-polity as an *independent variable* and on the *process of integration*.

The two last decades we witnessed the empowerment of EU institutions compared to previous phases of integration and the increasing significance they have on member-states’ domestic and foreign affairs. Despite the fact that the EU engulfs distinct institutional cultures with balance of power fluctuating between intergovernmental and supranational jurisdiction over time, it has managed to reach a *modus operandi* of multilevel governance (MLG), which though is stretched to its limits as the number of member-states expands.<sup>8</sup> MLG is best described as a system of overlapping competencies among multiple levels of governments and the interaction of political actors across those levels. Member states executives are only one set of actors in the European polity. States are not an exclusive link between domestic politics and intergovernmental bargaining in the EU as those are the result of multi-level policy networks contacts and policy. The structure of political control is variable, dynamic and not constant, across policy areas.<sup>9</sup>

Today, the EU is the culmination of 60 years of evolution exhibiting many state-like attributes, such as an executive (European Council), civil service (European Commission), parliament, court of justice, single currency and single market, but not being a unitary state. At the same time, it sustains a mix of intergovernmental and supranational institutions, with common economic, environmental, foreign, military, social and transport policies, without being a confederation or federation. Instead, the EU is best described as a unique system of multilevel governance, which Kleinman (2002) described as ‘incomplete federalism’.<sup>10</sup>

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<sup>7</sup> Rosamond (2000), Ch. 1

<sup>8</sup> Rosamond (2000).

<sup>9</sup> Marks et al. (1996), p. 41.

<sup>10</sup> Mullen (2005) and Kleinman (2002).

### 2.3 The EMU and Its Politico-Economic Significance: Touching the Core of the Nation-State Once Again

In this context of EU's unique nature, the EMU represents the crown's jewel, the most ambitious integration policy that the EU ever embarked on; it represents *the* pivotal policy of economic and monetary cooperation which was deemed as necessary for completing the Single Market. At the same time, it touches on the heart of the nation state arriving from a different departure than the one that was firstly attempted in early 1950s, fostering or even demanding further integration for its smooth operation.

On a more practical level, a monetary system represents a crucial factor for national, regional or global economy. It facilitates international trade, foreign investments and economic interdependence and is considered as a prerequisite for a growing economy. The basic goals of a monetary system are to provide liquidity, to be adaptable and to ensure trustworthiness and credibility.<sup>11</sup>

Additionally, there can be little doubt on the politico-economic significance of the existence of a monetary system, let it be regional or global. A monetary system is not a neutral factor as regards the balances of power and the relations that are formulated between states. It affects with direct and indirect way states' interests. History has shown that the rise or the demise even of empires has strong correlation to the emergence or the decline of a monetary system or to the access gained to valuable raw materials that equaled to the issuance of more—but not inflationary—money. David Hume was one of the first economic philosophers that had accurately underlined the significance of money and its correlation to balance of payments and trade balance while Robert Triffin framed the issue within a more contemporary perspective. Even on an existential level, currency alone has increased political significance since it is:

- an expression of political existence in the International Community, closely related to concepts such as sovereignty and state,
- a symbol of political belonging to a community (society, country, region),
- a form of social bond within a community (society, country, region)

At the same time, the international environment within which the EU operates was fundamentally changed since 1990s resulting in a shifting of balance within the EU. Germany has emerged as the undeniable economic steam engine of Europe claiming a respective political role in EU politics. This development coupled with the pride that Germans took on the central role of the DM, played a significant role on EMU's structuring and Germany's influence. Even geography played its part as successive enlargements shifted EU's epicentre to central Europe.

All the aforementioned were reflected on EU's attempts to gradually advance a Monetary Union. Past experience had resulted in the establishment of the European

<sup>11</sup> Krugman and Obstfeld (2011), Chs. 18, 19, 20.

Monetary System in 1979. The first attempt to coordinate EU exchange had as an outcome the Exchange Rate Mechanism 1 which collapsed *de facto* in 1992 and *de jure* in August 1993 (Brussels compromise). However, its aftermath was valuable in two respects; first, it highlighted Germany's dominant economic and monetary role, which had dissatisfied many countries and was considered by many to be part of the problem and second, it created a culture of monetary discipline and monetary institutions (European Monetary Institute that superseded the European Monetary Cooperation Fund and TARGET) that laid the foundation for and were succeeded by those of the EMU.

The Maastricht Treaty provided a new vision on Monetary Integration making reference to the creation of a Monetary Union based on the establishment of a Common Currency that would be managed by a common and independent European Central Bank. The model reflected, to a great extent, Germany's monetary structures and attitudes while it laid down the rules of this arrangement (Maastricht criteria). Still, contrasting views on EMU's future development had surfaced, the two main being the economist versus the monetary. Economists believed that the EMU is a political project that demanded supranational structures and harmonization of member states' economies before its establishment. On the other hand, monetarists sustained that the EMU is an economic project of technical nature that should not bear political implications and should be subjected to intergovernmental checks. Those checks should be applied on the process of EMU implementation, thus letting the institutionalization of this process to forge the economic convergence between its member states. Which one of those views was vindicated is still open to debate.

The motives for establishing the Monetary Union were the following:

1. Increase of Monetary stability & Economic Security against speculation.
2. Increase of Financial Credibility in International Markets.
3. Boosting of the Single Market that preceded the Monetary Union.
4. Increase of Economic power and independence in the International Political and Economic arena.

According to economic theory (Optimum Currency Area-O.C.A.), the economic rationale of a Monetary Union is:

1. Elimination of exchange rates fluctuations & devaluations
2. Greater price transparency
3. Reform of labor markets & opening up of economies to greater competition

which result in:

1. More efficient allocation of resources
2. Reduction of Cost of Capital
3. Price Stability
4. Boost of Productivity & Investments

5. Greater Prosperity: economic growth and development
6. Increase of Employment<sup>12</sup>

Whether the EMU has achieved these goals is still debatable. Some of those have been attained while others are still missing. Yet, it is beyond any doubt that the EMU still has to cover some distance for being considered an O.C.A. Today, the EU seems as a stateless economy, an entity that has state-like competencies on the economic field which though lacks the necessary system of political governance. The gap between politics and economics has always been tantalizing the EU and comprises the challenge to be answered ahead. The problem this time is that the EMU project has raised the stakes high as it influences the well being of millions of people testing the breakpoints of numerous European societies and their level of commitment to the European ideal. At the same time, EU's further development and EMU's effectiveness demand greater economic convergence and further integration on fields like fiscal policy, tax, social policy, banking and debt management, all of which imply the emergence of centralized government competencies. This is a multilevel and multi-actor puzzle to be solved, which poses demandingly enough the question of future EU economic and political governance fuelling scenarios of multispeed or core-periphery levels of integration.

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## 2.4 The EMU and the Challenges Ahead: Four Future Scenarios<sup>13</sup>

The EU and the Eurozone are standing at a crossroads, facing the biggest challenges in its history. The systemic crisis and the political attempts to overcome it have far-reaching consequences for the future of the Economic and Monetary Union, European integration and Europe in the world. By identifying, so far in this paper, the main driving forces that influence the future development of the Economic and Monetary Union, we may contemplate a number of different scenarios to show what the Eurozone will look like in the year 2020.

1. Muddling through the Crisis. The Eurozone remains a house without a protecting roof.
2. Break-up of the Eurozone. The Euro house falls apart.
3. Core Europe: Evolution of two-level integration with a smaller and stable, but exclusionary Euro house.

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<sup>12</sup> On O.C.A. theory, its economic rationale and effects: De Grauwe (2012), Demopoulos et al. (2001), Mousis (2005), Ch.7, Tsoukalis (2003), Krugman (1993), pp. 241–261, McKinnon (1963), pp. 717–725, Mundell (1961), pp. 657–665, (1968).

<sup>13</sup> Analysis based on the report produced by Friedrich Ebert Stiftung Institute, Scenario Team Eurozone 2020 (March 2013): *Future Scenarios for the Eurozone: 15 Perspectives on the Euro Crisis*.



4. Completion of the Monetary Union by a fiscal and political union. The roof is repaired and construction completed.

#### **2.4.1 Scenario 1: Muddling Through the Crisis: The Eurozone Remains a House Without a Protecting Roof**

According to this scenario, most of the Southern European countries still need rescue packages and the European Central Bank keeps on buying their public bonds, as the borrowing costs for them are too high. Given the increased needs in capital, the resources of the European Stability Mechanism are still inadequate and thus there is always the possibility of sovereign default.

The Economic and Monetary Union remains incomplete, unable to ensure growth and employment and, even less, a transition to a new growth model that is greener, smarter and more inclusive. Globally, Europe remains a weak player, whereas the United States and other big powers, such as China, have managed to overcome the crisis. As a result, the EU's dependence on financial support from external partners increases.

After many unsuccessful attempts the crisis management of the Eurozone continues basically as a muddling-through policy. Even with a stronger emphasis on growth and a certain relaxation of the rigid austerity policy after the German elections in autumn 2013, the basic principles of the crisis management implemented so far continue to prevail. The revised Stability and Growth Pact still exerts pressure towards regular reduction of the public debt and the structural public deficit and left little room for supporting public and private investment.

Fiscal consolidation remains difficult in many Member States because the growth rate is too low. The long-term sustainability of welfare systems is eroded. The Euro Plus Pact and all other attempts committing the Member States to further convergence of corporate taxation and social contributions/benefits can not be implemented. There are neither significant changes in the European instruments for supporting investment nor macroeconomic coordination for growth. Nor is there a European industrial policy to complement European trade policy. The European strategy for growth remains limited to completing the Single Market and structural reforms. In this context, the opportunities of the Single Market and of external markets particularly benefit countries with public and private financial resources to invest.

#### **2.4.2 Scenario 2: Break-up of the Eurozone: The Euro House Falls Apart**

According to this scenario, the EMU is split up into different blocs and some countries have reintroduced their former currencies. The EU still exists, but is reduced to a loose alliance in which even free trade is seriously hampered by protectionist measures in many Member States. In some of these countries,

anti-European and nationalist-populist movements have come to power and pursue a beggar-thy-neighbour policy. In the weakened economies, many strategic assets are bought up by non-European countries, reducing Europe's control over its own production chains.

The crisis management within the EMU, which started in 2010, continues in more or less the same way in the following years, leading to a worsening of the situation. Access to financial resources remains subject to constant uncertainty. Regulation of the financial system to reduce volatility and undue pressure is confronted with substantial resistance and disagreements. The European financial supervisory bodies are weak and there is a number of bottlenecks in interbank lending across the Member States, which can not be reduced by last-resort provisions of liquidity from the European Central Bank. A chronic credit crunch prevails, deepening the recession in several countries. Differences in borrowing costs across the Member States are too high and, since the resources of the European Stability Mechanism are too low, sovereign default or severe and disorderly debt restructuring become a reality in some countries, with contagion effects on sovereign debt and banks.

Even a new Stability and Growth Pact will put pressure on Member States to systematically reduce public debt and structural public deficits, leaving little room for promoting public and private investment. Fiscal consolidation becomes impossible in several countries because they remain mired in recession over a longer period. Welfare systems are still undermined and, in some Member States, partially dismantled, leading to a major increase in poverty.

### **2.4.3 Scenario 3: Core Europe: Evolution of Two-Level Integration with a Smaller and Stable, but Exclusionary Euro House**

According to the 3rd scenario, the EMU is completed by a smaller core group of Member States within the framework of a new full-fledged Treaty outside the EU treaties and excludes the non-Eurozone Members and even some Eurozone Members (2 level Europe). The EU still exists, but is mainly reduced to a huge free-trade zone which even can accept new members hostile to closer political integration (for example, Turkey). The core group has implemented fiscal union and is moving towards a real political union, while some EU members on the periphery fall far behind these developments. Member States trapped in a recession/stagnation with high unemployment and strong emigration flows, anti-European and populist parties come to power pursuing protectionist policies and thus resisting closer coordination of national budgets and programmes at European level.

Divergences across Member States regarding growth, investment and employment rates increases, even with the use of structural funds. There is a growing conviction that the crisis can be solved only by stronger cooperation and the implementation of a fiscal union in a smaller group of states in order to save the common currency. This latter movement would probably be led by the new German government following the 2013 elections, including France and some smaller

member states (core countries). Fiscal consolidation remains difficult in the countries outside the core group because their growth is too low. The long-term sustainability of welfare systems is strengthened in the core group but is also weakened outside it.

The Euro Plus Pact, with its commitments to further convergence of corporate taxation and social contributions/benefits, is implemented, but only in the core group. New financial resources for investment, combined with a European industrial policy, the Single Market and appropriate structural reforms, foster the transition to a greener, smarter and more inclusive economy in the core group. More organised and competitive European production chains under the leadership of the core group are better able to reap the potentials of the European Single Market and global markets. The downside of these effects is growing inequalities between core and periphery, to be seen in growth rate divergences and increasing current account imbalances.

#### **2.4.4 Scenario 4: Completion of the Monetary Union by a Fiscal and Political Union: The Roof Is Repaired and Construction Completed**

The Eurozone, is built on a more consistent Economic and Monetary Union, coordinates its external position and there is a single Eurozone representation in the Bretton Woods institutions. The Euro becomes a reference currency attracting financial resources from all over the world. On the way to political union, a two-speed Europe emerges, in which the Eurozone as a vanguard of states explores closer integration. Non-members of the Eurozone are encouraged and assisted by the vanguard to meet the preconditions for integration, which encompass more than the Maastricht Criteria.

Different attempts to solve the crisis proved to be insufficient. The situation constantly worsens, with massive social unrest and anti-European movements gaining ground. Countries such as Germany and the Netherlands are now affected by the crisis and ensuing social discontent. Led by France and following the German elections of 2013, political leaders come to the conclusion that only a leap forward can solve the problems. Closer involvement of the Member States and European citizens in decision-making also strengthen popular support for European integration, weakening the influence of anti-European and populist parties.

A revised Stability and Growth Pact puts pressure on Member States to constantly reduce their public debt and structural public deficits, but leaves room for promoting smart public and private investment. Balanced budgets pave the way for more credible fiscal consolidation. The long-term sustainability of welfare systems is also strengthened. The Euro Plus Pact, with its commitments to further convergence of corporate taxation and social contributions/benefits, becomes easier to implement. A European debt agency ensures joint issuance of public bonds as a last resort, when issuance at national level reaches unreasonable levels. This favours lower and more reasonable borrowing costs in general.

The European Stability Mechanism is equipped to provide financial assistance with a clear but balanced conditionality, deploying more effective and rapid rebalancing and recovery programmes. Investment, growth and job creation are supported by stronger European instruments, notably Community Programmes, mobilising Community budget resources. EIB loans, guarantees and bonds, private project bonds and other available financing sources are issued, such as pension funds or taxation sources, including a financial transaction tax. These new resources for investment, combined with a European industrial policy, the Single Market and appropriate structural reforms, foster the transition to a greener, smarter and more inclusive economy.

More organised and competitive European production chains are able to better reap the potential of the European Single Market and global markets. The macro-economic surveillance process is also used to improve macroeconomic coordination in the European economy, taking positive advantage of spillover effects. Macroeconomic surveillance is coupled with stronger resources for catching up: not only swifter implementation of the structural funds but also a European Fund for Economic Stabilisation to deal with asymmetric shocks.

Social dialogue and bargaining are also encouraged at national and European level to better align wages and productivity. Differences with regard to investment, growth and employment rates decrease and regions lagging behind can more realistically catch up in terms of competitiveness, social and environmental standards, as well as reduce their external economic and financial deficits. Altogether, the European Union is well on the road towards real (also political) integration.

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## **2.5 The Road Ahead and Challenges for the EU**

The euro area's ambitious reform agenda includes a battle on three fronts:

- Fire-fighting actions to keep the crisis economies' (Southern Europe) adjustment Programmes on track;
- Establishment of closer institutional ties to shore up the footings of the single currency;
- Supporting a broadening and deepening recession by demanding more by way of monetary support.

In this context the European Commission issued a "blueprint for a deep and genuine economic and monetary union that includes the following two proposals:

1. To establish a euro area budget;
2. To issue common public debt.

Thus, consistent to its legacy of historical development through qualitative leaps forward, the EU is called over the next 6–18 months to proceed to:

1. the implementation of the “six pack” agreement (3 regulations relating to budgetary surveillance, 2 procedures for monitoring macroeconomic imbalances and 1 directive imposing minimum standards for national budgetary frameworks) and to
2. the implementation of the “two pack” agreement (tools for budgetary surveillance and for dealing with financial instability and the establishment of the Single Supervisory Mechanism to break the links between banks and individual governments).

In the meantime, economic cyclical indicators in the euro area remain depressed portraying an unfavorable picture. The unemployment rate has been rising for the past year and a half while GDP growth for the currency bloc remains very weak and economic growth differences across countries are remain significant (positive growth in Q2 13 but below trend, probably until the end of 2014-See Annex 2). The slide in activity is likely to cause a fresh headache for the ECB as it seeks to meet its inflation mandate. With the refi rate at 0.75 % and the deposit rate at zero, the scope for cutting short-term rates further is highly limited, implying the need for quantitative monetary support via asset purchases.

Given this rather troublesome economic environment the priorities of the ECB in the near future seem to be the following with the issuance of the Eurobond waiting at the end of this course:

1. To restart the financing of peripheral economies;
2. To launch the Outright Monetary Transaction (OMT) programme before considering additional measures;
3. To cut the refi rate and look at possible additional unconventional measures to restart the financing of SMEs.
4. To be harnessed to avert insolvency with or without the EFSF;
5. To intervene in some markets to prevent insolvency;
6. Some degree of expansionary policy on the part of the ECB is necessary for a solution to Europe;
7. The ECB should issue ECB bonds to maintain the right track of monetary policy;
8. Eventually, those ECB bonds could be retired in exchange for Eurobonds. Eurobonds could follow.

Still, the risks of this highly complex situation remain as the business sentiment is bottoming in most euro area countries, while remaining well below the historical average and economic activity remains driven down by the ongoing fiscal tightening, credit restraints in peripheral countries and private sector deleveraging. Despite the impressive improvement in financial markets following ECB's OMT, there is little transmission to the real economy. The double-dip recession could have been avoided if euro area governments had reacted more swiftly and more efficiently to renewed tensions in sovereign debt markets which is still in existence. The decision to launch an enhanced integration of the euro area shortly is an important milestone in the crisis resolution and should gradually restore sound financial conditions

across the board. Discussions about the architecture of EMU are likely to be chaotic, and tensions could resume temporarily in the meantime.

With significant progress in 2013 and the structural reform agenda gaining momentum, it is likely to have 1.4 % GDP expansion in 2014, which though is not sufficient to restart job creation. In this respect, unemployment is expected reach a record high in peripheral countries, peaking at double-digit record highs.

As for the Greek conundrum, the Eurogroup's Greek package buys time, but does not deal conclusively with the funding gap (it falls well short of a complete solution). On the positive side, the release of funds that the deal facilitates means an outright default will be avoided for the time being. The disbursed funds should allow important progress to be made with bank recapitalization. In effect, time has been bought for the government to demonstrate a renewed willingness to undertake reform, and it might be in a position to report a primary surplus in 2014, which would be a striking achievement. On the downside, it remains unclear whether new funds will be committed to the programme. The program is likely to have to be reviewed within the next couple of years (possibly after next September's German elections). An outright haircut on EU loans of at least 20 % is likely to be needed if Greece's public debt trajectory is to be put on a convincing downward path.

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## 2.6 Conclusions

There is no doubt that the EU comprises the most successful peace project in history which in the course of time developed such economic and policy competencies that transformed it to a unique international actor. The EU stands as a colossal and unique enterprise that has succeeded in reviving European societies and economies from the ruins of WWII and secured the most long-lived period of peaceful coexistence in Western Europe.

The integration process has not always been smooth and economically or politically costless. This achievement was realized through a painstaking progress, applying a careful incremental approach to the expansion of EU competencies, many times by performing a qualitative leap forward for breaking the mould and lifting a deadlock. Today, the EU has been evolved into an international entity bearing state-like attributes and a developed system of multilevel governance that entails overlapping competencies among multiple levels of governments and the interaction of political actors across those levels.

The expansion of its competencies was bound to push the boundaries of national sovereignty challenging the role of the state. This development has not come unanswered; rather it has created many frictions on international, economic, political and social level. The EMU represents one of those policies that touch on the heart of the notion of the nation state influencing, at the same time, the social and economic reality of millions of people.

While the EMU is far from being characterized a complete Optimum Currency Area, it has managed to tackle the outbursts of the Euroarea crisis, while setting up institutions and regimes that are necessary for its effective management. Still, for the EU to realize the completion of the EMU and a form of political union, it would

take once more a qualitative leap forward to be taken that will break the mould and refresh the vision of European integration. This would entail:

- Closer involvement of the Member States and European citizens in decision-making
- A revised Stability and Growth Pact that leaves room for promoting smart public and private investment.
- A European debt agency that ensures joint issuance of public bonds as a last resort
- The furnishment of the European Stability Mechanism with tools to provide financial assistance with a clear but balanced conditionality.
- New sources of investment such as the issuance of EIB loans, guarantees and bonds, private project bonds and other available financing sources (pension fund, financial transaction tax).
- Effective and coordinated macroeconomic surveillance process coupled with stronger resources for facilitating weaker states to catch up.
- Encouragement of social dialogue and bargaining at national and European level to better align wages and productivity.

In the context of this strategic plan, pivotal actors as the European Commission and the ECB are called to take bold steps towards the resolution of this crisis taking the integration process to the next level. Actions that would encourage such development are:

- the establishment of a Euroarea budget,
- the issuance of common public debt (Eurobonds).

Today, the EU stands at a crossroad. Past EU experience has shown that such a situation represents more of an opportunity to move forward and less a threat to its existence. Those who are brave enough to abide to the new framework that is setup are those who get onboard EU's future progress. All that is needed is bold political will, effective decision making, vision on EU's *finalite*, closer involvement of the European citizens in EU activities and solidarity to EU societies.

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## Annexes

### Annex 1: Theorizing EU Integration<sup>14</sup>

*Federalism* It draws its theoretical basis to the writings of Coudenhove-Kallergi<sup>15</sup> and Alterio Spinelli.<sup>16</sup> Its aim was to make a new post-war start on a radically different basis from the Europe of national states. It aimed to achieve a complete

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<sup>14</sup> See Rosamond (2000) and Dinan (2000, 2010).

<sup>15</sup> Coudenhove-Kallergi (1926).

<sup>16</sup> Spinelli (1972).

break from the old order of nation states, and to create a federation of European states. Its guiding principle is the study of federal systems in designing an adequate European *modus opreandi* putting institutions first.

*Functionalism* It was particularly associated with the writings of David Mitrany.<sup>17</sup> It was a theory of how to achieve world peace, rather than a theory of regional integration. It took a very different approach to the question from the European federalists, who wanted to subordinate national governments to an overarching federal authority.

He opposed the idea of a single world government or the creation of regional federations, believing that this would simply reproduce national rivalries on a larger scale. Instead, he proposed the creation of a whole series of separate international functional agencies, each having authority over one specific area of human life. His scheme was to take individual technical tasks out of the control of governments and to hand them over to these functional agencies. He believed that governments would be prepared to surrender control because they would not feel threatened by the loss of sovereignty over, say, health care or the co-ordination of railway timetables, and they would be able to appreciate the advantages of such tasks being performed at the regional or world level.

*Transactionalism* It is founded on Karl Deutsch's theoretical constructions.<sup>18</sup> It refers to the build up of security communities (Ferdinand Tönnies: "Gemeinschaft") as entities where the component governments either retain their separate legal identities or form an institutional fusion. Its main hypothesis is founded on the existence of a sense of community among states that serves as a critical link on the level of communication between them.

*Neofunctionalism* This theory draws on the works of Mitrany and Monnet in particular. The main figures in this school of thought are Haas (1968), Leon Lindberg (1963, 1966), and Philippe Schmitter (1970).<sup>19</sup>

Neofunctionalism sought to explain how and why the states voluntarily interact closely with their neighbours blurring the boundaries of their sovereignty while acquiring new techniques for resolving conflict between themselves. Neofunctionalists were pluralists in the sense that they argued that the international activities of states were the outcome of a pluralistic political process in which government decisions were influenced by pressures from various interest groups and bureaucratic actors.

Using the concepts that were later called 'transnationalism' and 'transgovernmentalism', neofunctionalists expected nationally based interest groups to make contact with similar groups in other countries (*transnationalism*) and departments

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<sup>17</sup> Mitrany (1966).

<sup>18</sup> Deutsch (1966, 1968).

<sup>19</sup> Haas (1968), Lindberg (1963), Schmitter (1970).



of state to forge links with their counterparts in other states, unregulated by their respective foreign offices (*transgovernmentalism*).

The advocate integration in areas of “low politics” which are at the same time “strategic economic sectors” under the auspices of a high authority to promote the integration process. According to their theoretical framework, the integration of particular economic sectors across nations would create functional pressures thus gradual entangling the national economies. Deepening economic integration will create the need for further European institutionalization as social interests would put faith to the new supranational center. Political integration and supranational institutionalization would result as side-effects of economic integration.

*Intergovernmentalism* In response to the neofunctionalist analysis of European integration, a counter-argument was put forward by Stanley Hoffmann (1964, 1966).<sup>20</sup> This argument drew heavily on realist assumptions about the central role of the government of states in the international arena.

European integration should be seen in a global context. This is characterized by an international system ruled by anarchy (in the sense of the absence of a global regulating authority of international relations), composed of the states (sovereign entities that are formally and functionally equal). The key variable is the distribution of capabilities and power across states. Anarchy can produce order, but cooperation between states is always limited by the nation state's strive to survival. Rational states seek to maximize the possibilities for their survival. Interests and actions of the most powerful states constitute the nature of the international system creating patterns/norms and shaping its limits.

This framework conditions the European Union as well, despite the existence of supranational structure of authority. As a result, European Integration progresses only as long as national interests coincide. Only then governments accept further integration in technical functional sectors and low policy areas. Integration fails to spread to areas of high politics that touch on the core of nation state sovereignty (be it national security, defence or other that challenge the nation state's existence).

*Liberal Intergovernmentalism* came to enrich this school of thought rounding up some of its approaches based on A. Moravcsik's work.<sup>21</sup> This theory claimed that Theories of European integration had to be supplemented by more general theories of national responses to international interdependence. It was sustained that the unitary approach to state behaviour failed to explain the transfer to authority to supranational institutions. Moravcsik focused on domestic politics and how they influence governments in international negotiations, as the latter try to balance between economic interests in the domestic arena and national interests in the international arena.

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<sup>20</sup> Hoffman (1964, 1966).

<sup>21</sup> Moravcsik (1993) and Moravcsik (1998).

*Social Constructivism* This school of thought draws on the works of Alexander Wendt, Antje Wiener, Thomas Diez, Thomas Risse and Peter Katzenstein.<sup>22</sup> Constructivists hold the view that the building blocks of international reality are not only material but also ideational. Ideas matter and have normative as well as instrumental dimensions, that they express not only individual but also collective intentionality. Moreover, the meaning and significance of ideas are not independent of time and place.

In turn, other factors shape the international system as well such as the social interaction of states on the inter-national system, national norms on international politics, the impact of European norms on changes in domestic politics, the type of governance and their impact (cooperation of states, federal state, Economic Community, network) on political actors in Europe.

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## Annex 2: Tables

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<sup>22</sup> Indicative reference: Wiener and Diez (2009).

**Table 2.1** Real GDP and consumer prices in major global economies

	Real GDP				Real GDP				Consumer prices			
	% over previous period, saar				% annual chg				% over a year ago			
	3Q12	4Q12	1Q13	2Q13	2011	2012	2013	2014	3Q12	4Q12	1Q13	2011
Global	3.1	3.3	3.3	3.3	3.8	3.1	3.3	4.0	2.6	2.9	2.9	3.9
Developed	1.0	0.6	1.1	1.4	1.4	1.2	1.2	1.9	1.7	1.8	1.6	2.5
Emerging	5.3	6.0	5.6	5.2	6.5	5.0	5.5	6.0	4.4	4.8	5.3	6.4
BRIC	6.6	7.6	6.7	5.8	7.6	6.0	6.5	7.0	3.6 ↓	4.4	5.1	6.7
America	2.8	2.6	2.0	2.6	2.6	2.4	2.4	2.8	3.0	3.3	3.1	4.3
United States	2.7 ↑	2.5	1.5	2.0	1.8	2.3	2.1	2.5	1.7	2.0	1.7	3.2
Canada	0.6 ↓	2.0 ↓	2.0	2.0	2.4	1.8 ↓	1.9 ↓	2.2	1.2	1.5	1.4	2.9
Brazil	2.4 ↓	1.7 ↓	3.3	4.1	2.7	0.9 ↓	3.0 ↓	3.6	5.2	5.4	5.4	6.6
Japan	-3.5	-1.8	1.2	0.6	-0.7	1.6	0.1	0.9	-0.2	0.0	-0.1	-0.3
Australia	2.4	2.4	3.3	2.8	2.1	3.6	2.8	2.0	2.0	3.0	3.6	3.3
China	8.4	8.5	7.4	7.4	9.3	7.6	7.6	8.1	1.9	2.4	3.4	5.4
India	4.2	6.8	10.0	5.6	7.4	5.5	6.7	7.4	7.8	8.2	8.0	9.5
												7.8
												7.0
												5.7

Source: IMF Global Economic Outlook

**Table 2.2** Real GDP and consumer prices in major European economies

	Real GDP				Real GDP				Consumer prices				Consumer prices			
	% over previous period, saar				% annual chg				% over a year ago				% annual chg			
	3Q12	4Q12	1Q13	2Q13	2011	2012	2013	2014	3Q12	4Q12	1Q13	2011	2012	2013	2014	
Euro area	-0.1	-1.1	0.1 ↓	0.7	1.5	-0.4	0.1 ↓	1.4	2.5	2.3	2.0	2.7	2.5	1.8	1.7	
Belgium	-0.1	-1.0	0.5	1.3	1.7	0.1	0.4	1.6	2.3	1.9	1.4	2.3	2.3	1.4 ↓	1.5	
France	0.9	-0.5	0.2	0.5 ↓	1.8	-0.2	0.3 ↓	1.7	2.4	2.3	2.2	3.5	2.6	2.0 ↑	1.4	
Germany	0.9	-0.7	1.4 ↓	2.3	3.1	1.0	1.2 ↓	1.8	2.1	2.0	1.9 ↑	2.5	2.1	2.0 ↑	2.5	
Greece	-3.2	-5.3	-5.0	-4.3	-3.2	-5.3	-5.0 ↑	-4.3	-7.2	-5.9	-4.1 ↑	3.1	1.1	0.1 ↓	-0.5	
Ireland	2.4 ↑	0.6 ↑	1.1 ↑	1.5 ↑	1.4	0.4	1.3 ↓	2.4	2.3	2.1	1.5	1.2	2.0	1.0	1.3	
Italy	-0.7	-2.0	-0.8 ↓	0.2 ↓	0.6	-2.1	-0.8 ↓	1.0	3.4	2.6	2.0	2.9	3.3	2.0	2.0	
Netherlands	-4.1	-1.8 ↓	-0.3 ↓	0.4	1.1	-1.0	-0.6 ↓	1.2	2.6	3.3	3.1	2.5	2.8	2.6	1.3	
Portugal	-3.3	-3.1 ↑	-1.9 ↓	-0.3	-1.7	-3.0	-1.7	-0.8	3.0	2.0	1.2	3.6	2.8	0.9	0.4	
Spain	-1.1	-2.5 ↑	-1.9	-1.1 ↓	0.4	-1.4	-1.5	0.8	2.8	3.2	2.6 ↓	3.1	2.5	1.9 ↓	1.1	
United Kingdom	3.9	-0.2 ↓	1.6	1.9	0.9	-0.1	1.4 ↓	2.1	2.4	2.6	2.5	4.5	2.8	2.8	2.4	
Switzerland	2.3	0.8	1.2	1.2	1.9	1.0	1.2	1.5	-0.5	-0.2	0.5	0.2	-0.7	0.9	1.5	
Sweden	0.8	-1.2	2.0	2.2	3.9	0.9	1.3	2.4	1.0	1.8	2.0	1.2	3.0	0.9	0.8	
Norway (mainland)	2.1	2.6	2.8	2.8	2.4	3.4	2.8	3.0	0.4	1.2	1.3	1.2	0.6	1.5	1.7	
Denmark	-0.4	0.8	1.2	1.6	0.8	-0.1	0.9	1.8	2.5	2.3	1.7	2.8	2.4	1.9	1.8	
Russia	6.2	10.9	-0.1	-0.2	4.3	3.7	3.6	3.6	4.5 ↓	7.5 ↑	8.8 ↑	8.9 ↑	5.4 ↑	7.7 ↑	5.3	

Source: IMF Global Economic Outlook

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