

# **Changing the policies, politics, and processes of the Eurozone in crisis: will this time be different?**

**Vivien A. Schmidt**

## **Introduction**

The Eurozone crisis continues to pose major challenges for the EU and its Member States. The problems stem from the Eurozone's flawed policies, toxic politics, and rules-based processes. By framing the crisis as one of public debt (rather than private excess), then diagnosing the causes of the crisis as behavioural (Member States not following the rules) rather than structural (linked to the euro's design), EU leaders produced policies that have failed to provide lasting solutions to the crisis. Underpinning the mistaken analysis is EU leaders' long-standing policy narrative about the euro, promising that it would produce convergence toward export-oriented growth and 'competitiveness' so long as Member States followed the stability-based rules. When the sovereign debt crisis struck, rather than seeking to fix the euro by adding the missing elements to monetary union, or seeking to moderate its effects through counter-cyclical policies, EU leaders doubled down on the rules, insisting that growth would follow from fiscal consolidation (rapid deficit and debt reduction) for all, combined with structural reforms (focused on increasing labour market flexibility and reducing social welfare costs) for those countries falling foul of the rules.

The policies have left Europe at risk of deflation, with slow growth, high unemployment, rising inequality, and a humanitarian crisis threatening the poorest Europeans, in particular in Southern and Eastern Europe. The politics in response have become increasingly Eurosceptic and volatile, as citizens' loss of trust and confidence in national governments and the EU have resulted in the cycling of incumbent governments and the rise of extremist parties and populist movements. The processes have only exacerbated these politics and the economics.

EU governance processes have imposed major constraints on Member States' economic policy-making, thereby limiting their potential responsiveness to citizens' concerns at the same time that they have upended the EU's long-standing institutional balance. Eurozone decision-making has combined excessive intergovernmentalism (as the overly dominant European Council turned the Commission into a secretariat while sidelining the European Parliament) with growing supranationalism (as the European Central Bank (ECB) 'saved the euro' in exchange for Member State austerity and structural reform while the Commission took on an expanding role in fiscal surveillance). The resulting EU policy-making processes have involved 'governing by the rules' and 'ruling by the numbers,' through macroeconomic stability-based rules setting specific numerical targets for deficits and debt, with austerity and structural reform mandated for those who fall foul of the rules and numbers.

For all this, 2014 may very well come to be seen as a watershed year for the EU. The European Parliamentary elections, in which for the first time the leader of the winning majority was appointed President of the EU Commission, may serve to reinforce the influence of the European Parliament (EP) while increasing the political legitimacy of the Commission and, thereby, its autonomy vis-à-vis the Council. Moreover, politics have come back in not only through the EP election campaigns across the EU but also via the Council, as some Member States contested the rules and pushed for greater flexibility in the processes. As for the Commission, it has become more and more flexible over time in its interpretations of the rules, even as the ECB has successively reinterpreted its mandate — both for better results. The problem is that all EU actors have essentially reinterpreted the rules 'by stealth': by not admitting it in their discourse. Although such incremental changes to the rules do help, they cannot solve the crisis, especially because the silence about the need for change cuts off debate about what could and should be done.

So the question is whether significant changes in the policies, politics, and processes will take place in 2015. The EU has a new EP, a new Commission with a new Commission President, a Council with some new faces, and the recognition by all and sundry that the EU economy remains in trouble. But will this time really be different, with EU actors taking the bold steps necessary to solve the crisis once and for all? The

response to the Greek crisis in July 2015 suggests not. And little is likely to change in any case with regard to the overall policy programme until EU leaders change their policy narrative about the euro and about the sources of growth, which demands significant investment as well as a loosening on the demand side rather than continued austerity or even just stability. Tinkering around the edges of the policies and the narrative is not likely to be enough.

In an effort to suggest ways in which this time could be different, this chapter offers proposals for further European economic integration, discussing the challenges and opportunities, possible economic initiatives, and suggestions for revamping fiscal surveillance as well as decentralising the European Semester. The chapter ends with thoughts about how to rethink the future governance of the Eurozone as well as European Union governance. It begins with an analysis of the problems of Eurozone policies, politics, and processes.

## **1. Challenges posed by the Eurozone crisis: policies, politics, processes**

### 1.1 The problems of the Eurozone

The problems for the Eurozone go back to its beginnings in the Maastricht Treaty in the early 1990s. Member States at that time gave up monetary sovereignty without setting up a common pool of centralised resources. Instead, fiscal responsibility remained within the Member States along with the long-established principle of Member State responsibility for covering the social costs of adjustment. Whatever the reasons — such as a desire to maintain control over national budgets and resources or a fear of having to pay for the mistakes of others — this meant that the Eurozone was unprepared to respond to a major crisis. But having no mechanism in place once a crisis of this magnitude struck was a major challenge. It required vision and courage, both of which turned out to be in short supply.

With the economic crisis beginning in 2008, instead of imitating the US and the UK, with an aggressive monetary policy, major fiscal stimulus, and an immediate cleanup of the banking sector, the Eurozone had a passive monetary policy, introduced a stimulus that was stopped too soon, and paid little attention to the banking sector. Furthermore, when the sovereign debt crisis hit in 2010, the monetary authorities (ECB) continued to deploy a restrained response, the political authorities (Council) pushed fiscal tightening, and EU institutional actors generally, fearing the financial markets' response, did not make private creditors bear the losses, which were transferred instead to in-country public authorities (and taxpayers) (see, e.g., Mody 2015). Moreover, in exchange for the creation of loan-bailout mechanisms to provide 'economic solidarity' for countries at risk — the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) — EU Member States signed up to ever-more rigid legislative pacts and treaties.

Fiscal austerity and belt-tightening followed across Europe. Moreover, for countries in trouble, loan bailouts were provided at punishing interest rates without any initial debt restructuring and with programmes mandating rapid deficit reduction and structural reforms. For countries at risk of needing a programme, policies of rapid deficit reduction were also implemented. In both instances, the demand for rapid deficit reduction guaranteed that governments would engage in across-the-board cuts that reduced growth prospects not only in the short-term — through significant economic contraction that massively increased unemployment and debt-to-Gross Domestic Product (GDP) ratios — but also in the medium-term by cutting education (see Agostini and Natali this volume), training, and Research & Development (R&D) support. Additionally, government reductions in public sector wages, pensions, social assistance, healthcare (see Stamati and Baeten this volume) and other public services also brought social injustice to the level of a 'humanitarian crisis.' The poorest citizens of these countries found themselves without access to adequate nutrition, affordable healthcare, or shelter while increasingly high unemployment produced waves of emigration of the more highly skilled, especially youth (see reports by Council of Europe 2013, Caritas Europe 2015, and the EP 2015).

As a result, after over five years of austerity and structural reforms, the EU is still in the midst of economic crisis. Although the worst moments of the crisis — between 2010 and 2012 — may be behind us, the crisis continues to burn, if more slowly, in the face of deflationary pressures, continued high unemployment, with poverty (Frazer *et al.* 2014) and human rights violations (Council of Europe 2013; European Parliament 2015) making for a tangible increase in ‘human misery’ across Europe.

## 1.2 The Eurozone’s flawed policies

The Eurozone’s problems can be blamed largely on the flawed policies that have contributed to the EU’s poor economic performance. These policies involve failures with regard to crisis framing, diagnosis, choice of remedies, and a lack of deep solutions.

The first of the failures stems from the (mis)framing of the crisis as one of public profligacy, which was inappropriately generalized from the case of Greece. For all other countries, the problem was rather one of private debt resulting from the massive overstretch of the banks, the increasing indebtedness of households, and the mispricing of sovereign risk by the markets (De Grauwe and Ji 2012; De Grauwe 2013; Blyth 2013). But framing the crisis as one of public debt in the periphery fueled resistance to any form of deeper economic integration on the fears that it would create a ‘transfer union’ in which Northern Europeans would pay for debts accrued in the South.

The second failure is the (mis)diagnosis of the problem as behavioural, seen as emerging from the Member States’ failure to follow the rules of the Stability and Growth Pact (SGP) (Jabko 2015). Throughout the 2000s, Member States in the periphery like Spain and Ireland were models of rule following, in contrast to countries like Germany and France, which broke the rules in the mid-2000s (albeit for good reasons, i.e., not to cut spending in a recession). The real problem was structural, in which the ECB’s ‘*one size fits none*’ inflation-targeting monetary policy produced increasing divergence rather than convergence between surplus and deficit countries (Enderlein *et al.* 2012; De Grauwe 2013; De Grauwe and Ji 2013). Insisting that all countries tighten their belts at the same time to become more ‘competitive’ ignores the interdependence of surplus and deficit

countries and the moving average problem at the heart of such efforts (e.g., Skidelsky 2013; Matthijs and Blyth 2011; Wolf 2013). Moreover, the policies themselves are fundamentally asymmetric in effect, since even if they might work for the export-led model of Northern Europeans, they leave Southern Europe with no alternative other than to enter into a never-ending downward spiral of wage repression (Scharpf 2013, 2014a).

The third failure comes from the chosen remedies, centered on procyclical policies of ‘sound’ money, budgetary austerity, and ‘structural reform,’ instead of counter-cyclical policies that could have generated growth through macroeconomic stimulus, industrial investment, and socioeconomic support (Scharpf 2012, 2013, 2014a; De Grauwe 2013). The continued problems for Member States under surveillance or in programmes had much less to do with their indebtedness or ‘competitiveness’ than with the ‘sudden stop’ of market finance, itself due to the uncertainty generated by EU leaders’ pronouncements or (in)action with regard to deeper European economic integration (Jones 2010, 2015a).

The ultimate failure results from the lack of adequate solutions that leave an incomplete risk pool and insurance mechanism put in place more by default than design (Schelkle 2015; Jones 2015b). While critiques of the Eurozone as unworkable because it is not an Optimum Currency Area (OCA) are legion (e.g., Eichengreen 1991, 2012; Feldstein 1997), they all tend to assume by definition that the EU cannot share risk the way equally heterogeneous entities like the United States do through fiscal federalism (Henning and Kessler 2012). But although the EU will certainly never become a federal state like the US, there are many ways to deepen economic integration so as to make it more robust in terms of weathering asymmetric shocks and the pressures of the global financial markets. Alternative solutions would have been to complete the monetary union with a financial union (Jones 2015b) or even a fiscal union through some form of debt mutualisation (e.g., Eurobonds) plus macroeconomic stabilisers (e.g., an unemployment fund – Dullien 2012 – or a ‘cyclical adjustment fund’ – Enderlein *et al.* 2013).

The results of these policies speak for themselves in terms of their effects on citizens’ welfare, health, and job prospects. Youth unemployment was at 20.9% in the euro area as a whole in March 2015, with over 40%

in Italy (at 43.1%) and over 50% in Spain (50.1%) and Greece (50.1% in January) (Eurostat 2015). A Council of Europe report (2013) concluded that austerity programmes in response to the crisis had undermined human rights in key areas, largely as a result of public social spending cuts, and especially in countries under international bailout programmes – e.g., the Troika demand that public spending on health in Greece not exceed 6 per cent of GDP. For 2014, moreover, a Caritas Europe report (2015) detailed the extent of the problem, finding that more than 1/3 of the population in five EU Member States were at risk of poverty or social exclusion and one in three children live in poverty in 14 of the 28 EU countries. Additionally, a European Parliament (2015) report on seven countries detailed the slashes in spending on education, the transfer of health costs from state to citizen and the reversal in gains in citizen health along with a massive rise in unemployment. Most damning was the finding that spending cuts tended to ‘impose horizontal and indiscriminate cuts across the policy areas they targeted, to meet financial savings that were determined in advance’ (ibid.), rather than specifically target the wasteful uses of public resources. State administrative capacity in such countries has naturally been negatively affected by the cuts as well as by freezes in public sector wages. More generally, public investment in infrastructure has stalled across the Eurozone area, thanks to the ‘golden rule’ or ‘debt brake’ that Member States adopted as part of the rules – which also acts as an impediment to growth and competitiveness.

### 1.3 The EU’s increasingly volatile politics

As the Eurozone’s economic performance has worsened, citizens’ attitudes towards both their national governments and EU governance have declined dramatically. Citizen dissatisfaction has been fueled not only by the economics, however, but also by the politics in which seemingly apolitical decision-making processes at the EU level leave them little political recourse at the national level to change the policies (see Schmidt 2006). The result has been the increasing turnover of incumbent governments, the rise of new parties on the extremes, and a growing loss of trust in the EU and in national governments.

Increasing political volatility comes from citizens' perceptions that their preferences — whether expressed through the ballot box, social partnerships, social movements, or in the street — don't count (Mair 2013). The citizens' response to such perceived disenfranchisement has been to punish national politicians with growing frequency and intensity, leading to the increased cycling of incumbent governments (Bosco and Verney 2012). Disenchantment with national leaders has become the rule even in core countries, with France being a case in point: President Hollande has the lowest popularity rating of any president of the Fifth Republic (at 12% in November 2014). Governments are generally more fragile, with governing majorities often on a knife's edge, while winning mainstream parties have been having more difficulty forming governments. Even more problematic for the EU has been the emergence of anti-democratic governments, as in Hungary, and the continuing rise of far right extremist parties, such as the neo-Nazi Golden Dawn in Greece, the True Finns and the Sweden Democrats.

Increasing Euroscepticism and anti-European feeling is part and parcel of the political volatility. This is evidenced not only by the rise of the hard right extremes but also of the less extreme populists on the right, the left, and in the centre. Notably, such parties can be found not only in the countries hardest hit by the crisis, in Southern and Eastern Europe. They include those largely unaffected by the crisis economically, mainly in Northern Europe and Scandinavia (Taggart and Szczerbiak 2013; Usherwood and Startin 2013) as well as in Germany with the meteoric rise of the AfD (Alternative for Germany) in 2014. Importantly, public disenchantment with the EU can also be found in the polarisation of views across national European public spheres, in particular between Northern and Southern Europe (Kriesi and Grande 2015).

The only sign of light with regard to populist parties have been Greece's Syriza and Spain's Podemos (see Hyman this volume). What has made these new parties credible to large portions of the electorate has not only been that they engage openly with difficult questions about the distribution costs of fiscal consolidation, but also the fact that their initial exclusion from power puts them in a good position to bring real renewal to their countries' politics and generate citizen-friendly 'structural reforms' focused on reducing corruption, improving tax

collection, and promoting social justice. They oppose the continuation of austerity and structural reform programmes in their current form. With the electoral victories of Syriza to national office and Podemos to local office (most notably to the office of mayor of Madrid), their ability to deliver on their promises will be put to the test. For the moment, however, it is too early to say what effect they will have, although the protracted negotiations of Syriza with the EU on a new debt package suggest that they have not been able to change the Eurozone policy narrative or the agenda, much as they have tried. The main question for Syriza, then, will be whether it manages to bring much needed reforms to the country in the domain of anti-corruption efforts, strengthening state administrative capacity, and collecting taxes despite the continued austerity demanded by the Eurozone leaders.

At the EU level, the results of the European Parliament elections were also a sign of the rise of euroscepticism. Notably, Marine LePen's Front National (FN) received the largest share of votes in France and Nigel Farage's Independence Party (UKIP) in the UK — although Prime Minister Renzi's massive 40% victory for the social democrats (the PD, Partito Democratico) in the Italian contest (a first in the postwar history of Italy) suggests that all is not so dark. In the end, extremist parties now make up around 20% of Members of the European Parliament (MEPs).

Although the EP elections in 2014 did not do much to reverse the eurosceptic trend, they did stop the erosion in participation: the rate was only a half point lower than in 2009, at 42.54% in 2014. Despite the fact that national political concerns continued to dominate the vote, the debate was more centred on European issues. And the campaign itself was more politicised, thereby generating more citizen interest. EP parties ran their separate candidates for Commission President in EU-wide campaigns and held televised debates, even though the results were mixed in terms of citizen interest or awareness. While a majority of voters were aware of the 'Spitzenkandidat' in core European countries like Germany and France, most in the UK were not.

The problem of political legitimacy remains for the EP, however. The question is: how legitimate is a parliament for which 56.9% of the electorate have not voted? And how legitimate is that parliament when, among those voting, close to a third went for extremist parties that have

little chance in national elections? The elections have left the EP with a thinning center hemmed in by extremists of the right and left. As a result, the majority will necessarily be made up of a 'grand coalition' of centre right, centre left, and liberals, under the leadership of a former Luxembourg Prime Minister who was also one of the longest standing members of the European Council. Under these circumstances, the politicisation of the EP, in which debates and votes would be more clearly identifiable along traditional right/left lines in order to give citizens a clear choice among parties on the left and right, has yet to occur.

In the interim, the 2014 EP elections have also been important for EU decision-making processes. The appointment by the Council of the leader of the winning party as Commission President has conferred a new political legitimacy on the Commission and its President, as he now is the directly elected representative of the people. This may help rebalance the institutional equilibrium of Eurozone governance.

#### 1.4 The EU's rule-based governance processes

As a result of the crisis, the EU's long-standing 'democratic settlement,' in which all EU institutional actors were involved in decision-making in their different ways, has become unbalanced. Intergovernmentalism became the primary mode of governance, eclipsing the Community Method. The European Council became the predominant institutional player in Eurozone governance, with the European Parliament mostly absent and the Commission largely subordinate to the Council (Fabbrini 2013; Schmidt 2015). This shift has led Habermas (2011) to warn against the dangers of 'executive federalism,' in which the tremendous shift of economic and budgetary power to the EU level has occurred without any concomitant increase in citizens' political involvement.

Supranationalism has also increased significantly. Even as the Commission was weakened in its traditional role of initiator, it gained greater supranational powers of oversight in the context of the European Semester. Additionally, the ECB became arguably the most important actor when it came to responding to existential crisis moments, with its technical solutions accompanied by a political quid pro quo demanding

the Member States to engage in fiscal consolidation and structural reform. Moreover, the ECB's new responsibilities with regard to the Banking Union and the Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM) all increase its supranational powers, adding yet another set of supranational regulatory and bailout bodies to those already established, such as the ESM and the soon out-of-business EFSF.

The growing predominance of these two modes of governance is the outcome of the reinforcement of rules-based governance during the Eurozone crisis. At the inception of the euro's sovereign debt crisis, European leaders became obsessed with rules, numbers, and pacts, including the 'Six-Pack,' the 'Two-Pack,' and the 'Fiscal Compact,' each more stringent on the nature of the rules, more restrictive with regard to the numbers, and more punitive for Member States that failed to meet the requirements. In the absence of any deeper political or economic integration, the EU ended up 'governing by the rules' and 'ruling by the numbers' in the Eurozone (Schmidt 2015). Austerity policies focused on rapid deficit reduction along with pressures for structural reform — often shorthand for reducing labour rights and protections — wreaked havoc on 'social Europe,' in particular in countries in the periphery under conditionality.

Slowly but surely, however, under pressure from deteriorating economies and increasing political volatility, EU institutional actors have been reinterpreting the rules by which they have been governing the economy. They have done this in a variety of ways, such as by expanding their mandate, shifting emphases, approving derogations, or increasing flexibility. But they have not done this formally. Instead, EU actors have been informally and incrementally reinterpreting the rules without admitting it in their discourse to the public. This has helped to slow the economic crisis but not to end it. The reinterpretation of the rules 'by stealth' has done little to reduce public disaffection. Nor has it done anything for social Europe, as poverty, misery, and inequalities rise, as unemployment stays unsustainably high, and as both skills and hopes are lost for an entire generation of unemployed youth. In the previous Commission (2009-2014), only the 'youth guarantee' represented a pro-active attempt to deal with the social policy problems generated by the economic policy for the Eurozone. In the new Commission, in contrast, the new 'investment plan,' which promises to

raise €315 billion for investment in the real economies of Member States, at least begins to address the problems of growth.

That said, reinterpreting the rules by stealth has enabled EU actors to bring about incremental changes that have kept the European economy alive, though not well. Austerity has slowly been abandoned in favor of moderation, with structural reform now the principal rallying cry.

The European Central Bank (ECB) has moved from ‘one size fits none’ rules for monetary policy — which exacerbated (rather than reduced) Member States’ economic divergences — to ‘whatever it takes’ (in the famous phrase of ECB president Mario Draghi in July 2012). The pledge in 2012 to buy Member State debt if necessary and the promise in 2014 to engage in quantitative easing (begun in early 2015) has brought the ECB close to a lender of last resort in all but discourse (Buiters and Rahbari 2012) — although its Charter precludes full Lender Of Last Resort (LOLR) status. But although the seeming ‘hero’ of the crisis, the ECB’s push for strict conditionality through austerity and structural reform as a quid pro quo for its intervention to stop market attacks has contributed to the Eurozone’s economic slowdown and human misery. Moreover, the ECB also risks problems of political legitimacy when it sends secret letters to Prime Ministers threatening withdrawal of Central Bank support if they do not follow ECB demands. After the uproar in Spain in 2013 in response to revelations that Trichet had written to Zapatero, the issue again hit the headlines in November 2014 when it came to light that Trichet had written Irish PM Brian Lenihan a letter that essentially pushed the country into a harsh bailout package while protecting senior bondholders from losses in order to preserve confidence in the European banking system.

In the meantime, the Council has largely continued to govern by the ‘one size fits one’ rules of intergovernmental negotiation that have given the most powerful Member State (i.e., Germany) outsized influence to impose its preferences for ever-stricter rules (Jacoby 2015). This has unbalanced the traditional Franco-German ‘couple’ (Fabbrini 2013), with the Council now dominated by Germany in coalitional alliances with other Northern and Central Eastern European leaders. But even though Germany has kept up a discourse focused on austerity and structural reform, it has intermittently agreed to instruments of deeper integration and added growth to its stability discourse as well as, in

2014, flexibility. Notably, though, Chancellor Merkel claimed in a June speech to the Bundestag that flexibility was already embedded in the rules, so there was no need to change them. During 2014, France and Italy in particular pushed the Council for even more flexibility, politicising the budgetary oversight process of the ‘European Semester’ without, however, actually contesting the stability rules and numerical targets. Such politicisation was part of a game to legitimise themselves to national constituencies by ensuring ever more flexible rules-reinterpretation while using the EU’s outside pressure to keep up the internal push for reform. But although this strategy may have helped them legitimise their reform packages at home, it at the same time turns the EU into the scapegoat, and adds further grist for the populists’ mill.

In all of this, the EU Commission has taken on the role of enforcer. In the absence of real remedies to the crisis, such as a fiscal union or Eurobonds, the Commission was stuck with searching for solutions ‘like the drunk who looks for his lost keys under the lamp post’ because ‘that’s where the light is’ (Mabbett and Schelkle 2014). Recognizing this reality, as economic output performance deteriorated, the Commission increasingly made exceptions and flexible adjustments for non-programme countries, as in 2014 when it gave France and Italy further extensions on meeting the deficit criteria. But the Commission consistently denied its flexibility publicly — emphasizing its strict and uniform enforcement of the ‘one size fits all’ rules of budgetary oversight — so as to circumvent the political pressures and objections from pro-austerity Council members.<sup>1</sup>

The story has been different for programme countries. In the International Monetary Fund’s (IMF) (2013: 13) critique of the Greek bailout, it condemned the Commission for ‘the focus of its reforms more on compliance with EU norms than on growth impact.’ A similar critique was echoed in a June 2014 report by the French Commissariat on Strategy with regard to the European Semester, suggesting that the efficacy of the approach ‘merits discussion’ (Nicolaii and Valla 2014: 16). In fact, although the European Semester process became more open over time with regard to including social issues in considerations

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1. See Olli Rehn’s blog at [http://ec.europa.eu/archives/commission\\_2010-2014/blogs/rehn/](http://ec.europa.eu/archives/commission_2010-2014/blogs/rehn/).

and recommendations (Zeitlin and Vanhercke 2014), these were not necessarily translated into action by Member State governments. The heavy emphasis on rapid deficit reduction was most apparent in the Commission's Annual Growth Surveys, beginning with the 2011 report which put fiscal consolidation first, addressing unemployment through labour market reforms second, and leaving other more growth-friendly and socially concerned actions to third place. This ensured that Member State governments would address the deficit above all other things, largely without concern for growth or social justice. Notably, only in the 2015 Annual Growth Survey, written in November 2014 in view of the arrival of a new Commission, was the order reversed, with investment coming first (European Commission 2014).

Finally, even though the European Parliament (EP) continues to have almost 'no size at all' in terms of setting policy, its critiques of Council and Commission action along with its successful push to have the appointment of Commission President linked to the winning party in the EP elections has ensured it an increasing presence, if not yet influence over policy.

So where does the EU go from here? Incremental changes to rules are not the bold kinds of actions required to move Europe beyond the crisis once and for all. But they are for the moment all that is possible. In what follows, therefore, I make a few recommendations for further reinterpreting the rules along with EU actors' roles.

## **2. Further European economic integration, but how?**

The new realities of 2015 present a number of challenges and opportunities. The opportunities come from the potential rebalancing among EU institutions that follows the EP elections. The challenges follow from the continuing problems related both to the Eurozone's economics and politics.

### 2.1 Today's challenges and opportunities

The question for today is whether and how the Eurozone, with a new Commission and new institutional leaders, can provide some fresh

solutions by changing the policies, politics, and processes. Avenues already exist. Debates among political leaders in the Council have produced agreement that growth is to be the focus of economic policy, albeit not to the detriment of stability, and that flexibility is acceptable, so long as it remains within the established rules. The new Commission President has proposed an Investment Fund (see the chapter by Myant, this volume) and a range of other initiatives. Unfortunately, little in terms of lasting solutions providing deeper integration has been introduced into official discussions. However, there are a lot of ideas already out there, as EU institutional actors, think-tanks, academics, and some Member State leaders have already suggested a number of different ways forward.

The new realities of 2015 may also offer new opportunities to break the institutional impasse. The inauguration of new institutional leaders, with a new Commission headed by the leader of the newly elected majority in the EP, is promising with regard to restoring the institutional balance in the EU as a whole. Eurozone governance needs to become like most other areas of EU legislation, which means it should mainly use the Community Method for legislation. This would mean giving the EP more 'size' by bringing it into all Eurozone decision-making, while reducing the intergovernmental dominance of the Council in Eurozone governance. The EP's new direct connection to the Commission not only may give the directly elected representatives of EU citizens more voice in Eurozone governance affairs, and thereby give the citizens a sense that their voice counts after all. It may also increase the Commission's autonomy from the Council.

The Council itself should become a more open and transparent arena for political debate about the rules. Moreover, the ECB should limit its focus to euro-related issues of monetary governance, leaving economic policy orientation to the other institutional actors, while doing all the necessary work as quasi lender of last resort and bank supervisor.

Finally, the new Commission has greater potential independence with regard to taking bolder initiatives and proposing new ideas. This is as a result of its new double accountability – to the EP and the Council – as a result of the appointment by the Council of a Commission President who represents the majority in the European Parliament. Serving two

masters may actually give the Commission greater authority to exercise leadership independently of both.

This could re-empower the European Commission, enabling it to go back to doing what it does best, which is acting as a *vivier d'idées*, or a breeding ground of innovative ideas in which possible solutions on the right, left, and centre get debated and new syntheses proposed. Such re-empowerment could be crucial to finding new ways out of the Eurozone crisis, given the importance of technical actors in slow-burning crises in generating innovative ideas that political actors could take up in the fast-burning moments. It might also enable the Commission to tell the truth, that it is indeed exercising flexibility in its interpretations of the rules and calculation of the numbers, and enable it to provide legitimising arguments for why and how it is doing so.

The Greek crisis could have constituted a new opportunity to solve the EU's Eurozone Crisis. New negotiations on Greek debt, and the danger of Grexit brought a renewed fast-burning crisis that helped concentrate minds. The question was how to resolve this particular crisis in a win-win manner. It may help to recognize that large numbers of European citizens, not just Greeks, are fed up with austerity — witness the rise of Podemos in Spain, the protests against water fees in Ireland, the growing strength of Sinn Fein, and the rumblings in Portugal, not to mention the problems Hollande has had holding on to his left. The only good way out would have been to propose a solution that reset the whole EU approach. Instead, Syriza was pushed to accept continued austerity and structural reform in exchange for another bailout. Most concessions alienated not just the Northern European leaders, who felt that Greece had not followed 'the rules,' or the Central and Eastern Europeans, who were hostile because they went through harsh austerity too, and are poorer than the Greeks, but even other Southern Europeans, committed to continuing their own efforts to impose structural reforms.

The EU needs a reset in terms of policies, with a new vision and a new narrative about where it is going and why. Although this could have been a byproduct of the Greek crisis, it could not have been focused on Greece alone. The only way out is to take the high road, and to offer an overall way out of crisis for all Member States. But to do this is to move

toward deeper economic integration and some more quasi-‘federal’ solutions.

Any such solutions will not be easy. The problems stem from several sources: continued diverging preferences with regard to policy remedies, as discussed above; institutional obstacles such as the unanimity rule, in which any one Member State can veto any Treaty-based initiative; and legal obstacles, given the Treaty-basis of many of the rules. Equally problematic are differences in economic philosophies, in particular between the ordo-liberalism of Germany and EU institutions intent on getting Member States to solve their own problems by themselves and the more pragmatic approaches to economic governance supportive of more collective solutions. This especially affects potential EU-wide social policy solutions, such as proposals for a ‘social investment state’.<sup>2</sup>

## 2.2 Policy proposals for further economic integration

There are many arguments for further integration of the Eurozone, in particular in view of making it more effective and legitimate. The policy proposals listed below are not mutually exclusive, although some may serve similar purposes and are mutually substitutable. Many of these policies would make EU Member States more fiscally intertwined, and would therefore necessitate more EU policy coordination. The European Semester therefore would take on added importance (see next section).

- *Mutualisation of debt*: This could involve issuing Eurobonds (up to, say, 60%) to stop once and for all the market attack on sovereigns. Alternatively, repackaging old debt overhangs (especially Italy) and restructuring the debt or lowering interest rates to near zero while pushing the dates for repayment out to thirty years, fifty years or more. Neither of these alternatives requires much centralised coordination or deficit/debt rules. The

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2. Vandenbroucke with Vanhercke discuss ‘10 tough nuts to crack’ in this context ([http://europesworld.org/wp-content/uploads/sites/3/2014/03/03\\_03\\_14\\_Report\\_SocialUnion\\_FINAL\\_V-1.pdf](http://europesworld.org/wp-content/uploads/sites/3/2014/03/03_03_14_Report_SocialUnion_FINAL_V-1.pdf)).

mutualisation of debt via Eurobonds, once established, would enable the ECB to engage more readily in Outright Monetary Transactions (if ever required) and in quantitative easing (Claessens *et al.* 2012). This would mean that, much like US states, Member States could go bankrupt (and go to the ESM for a loan-bailout) without jeopardizing the whole system (Henning and Kessler 2012).

- *Emergency ECB Financing*: An alternative, however, in particular for countries under pressure from the markets, would be for the ECB — instead of flooding the capital markets with its 1.2 trillion quantitative easing programme (risking asset price inflation) — to be freed from the prohibition of monetary state financing and to provide emergency finance to Member States with above-average rates of unemployment (provided they accept and enforce no-exceptions wage stop for three years — the kind of Keynesian enforced short-term wage controls employed in the 1950s and 1960s to great effect)<sup>3</sup>.
- *Solidarity-Related Policy Instruments*: These could include a cyclical adjustment fund to stop countries from over-heating or over-cooling and/or an unemployment insurance fund. As funds, these instruments too would not require much in the way of policy coordination, just continued monitoring, as Member States put money in or take money out depending upon whether they are over-heating or deflating, or they are suffering from high unemployment (Enderlein *et al.* 2013).
- *EU Revenue-Producing Instruments*: Regardless of whether debt-related or solidarity-related instruments are generated for the EU, it also needs to have its own sources of revenue. This entails further integration and EU level coordination. The EU has little revenue generated for itself and instead depends on the Member States for resources for its operating budget. This has been highly problematic because the EU is consistently underfunded in terms of its operations, especially because much of its budget goes to the Common Agricultural Policy (CAP). As Maduro (2012) has argued:

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3. Thanks to Fritz W. Scharpf for this suggestion. See also Scharpf 1991: chapter 5.

‘financial solidarity in the EU must be detached from transfers between states and related, instead, to the wealth generated by the process of European economic integration.’ Examples abound:

- a *financial transactions tax (FTT)*, modeled on the Tobin tax initiative, and expanding the FTT already in process through enhanced cooperation for a limited number of Member States (but which seems to be slated to go into national coffers);
- a *European corporate tax* that could also involve harmonization of national corporate tax so as to ensure that European corporations pay a reasonable tax in their home countries, and that multinationals are no longer able to game the system, and instead pay appropriate taxes;
- a *Value Added Tax (VAT) on EU generated wealth* related to cross-border transactions and/or online sales (as part of the new EU Digital services market) that could pay for the spillover effects of the Single Market, geared to environmental, urban, and social problems (Maduro 2012);
- a *solidarity tax* (or fund) levied on all citizens and residents of the EU, targeted for poverty alleviation. Initially, it could be voluntary, possibly collected via national taxes through a box checked on national tax forms that would then be transferred to the EU to administer (Schmidt 2012).

## 2.3 The future of fiscal surveillance

There are a number of ways in which the new Commission has already been reinterpreting the rules and legitimating it. Most significantly, the new Commission has been presenting structural reform as a *quid quo pro* for greater flexibility through slower deficit reduction (e.g., in the cases of France and Italy — much to the annoyance of the Germans and the Finns). It had been even more explicit in the 2015 Annual Growth Survey that countries differ greatly in problems and potential solutions, so that there is no ‘one size fits all’ with regard to recommendations or decisions (European Commission 2014). The Commission has also stated that money pledged to the Juncker Investment Fund will not count against the deficit.

Further possibilities include:

- *Deductibility of Economic Investment*: For example, why not leave off the balance sheets growth-enhancing investments in infrastructure projects, education, training, research and development? This seems to be the idea behind the deductibility of Member State investment in conjunction with the Juncker Investment Plan, but why not make it the case for all such investment (Schmidt 2012)?
- *Deductibility of Social Investment*: Why not make any efforts toward improving skills and human capital deductible as part of the ‘social investment’ initiative of the EU that seeks to promote growth in knowledge-based economies and human capital (De Vincenti and D’Alema 2011).
- *Carrots and not just Sticks*: Beyond this, why not use carrots as well as sticks to encourage structural reforms, by providing project financing and poverty relief in exchange, or even just mandating that budget cutting for programme countries not interfere with the EU’s own goals for ‘Social Europe.’ Actually, why not make taking steps to accomplish Europe 2020 goals focused on investment in education, training, and R&D as well as on reducing youth unemployment and poverty count for delaying deficit reduction?
- *Try to find a way to make the statistics more transparent* and less punitive for countries in trouble. Eurostat calculations of country deficit and debt based on norms of comprehensiveness and ‘mark to market’ tend to disadvantage countries that the markets consider less viable. As an economy falters, and markets lose faith, statisticians are likely to re-categorize public enterprises as loss-making and therefore part of their deficit. This makes it much harder for already weak countries to recover, and makes it more likely that they will fall foul of the rules (Mabbett and Schelkle 2014: 15-17).

## 2.4 Decentralising the European Semester

The European Semester is highly centralised, largely to ensure sufficient consistency and adequate oversight in the Member State application of the stability rules. In this process, the Commission has been the ‘enforcer’ in a centralised exercise imposing hard and fast sanction-triggering numbers (however flexibly interpreted). Moreover,

as the Commission's own Annual Growth Strategy report (2015) admits, its democratic legitimacy 'has sometimes been called into question.' Its effectiveness is also in question, in particular since a low percentage of recommendations in country reports have been taken up. Moreover, the imperative of rapid deficit reduction meant that countries in programmes or at risk of programmes tended to implement across-the-board cuts that did nothing with regard to growth producing structural reform and were often socially unjust.

By empowering local actors through the decentralisation of the process, the European Semester could help generate more workable kinds of 'structural' reforms, fine-tuned for each Member State's political economy. Were the rules themselves to become more positively flexible within such a decentralised process, say, by encouraging Member State take-up of the Europe 2020 goals, the European Semester itself could become a boon for social Europe.

More generally, the Commission should be given a different role within a more decentralised system of supervision and support by opening up the process to national actors — experts, members of parliament, NGOs, labour representatives, and other stakeholders (see Zeitlin and Vanhercke, this volume). While the Commission should continue to coordinate policy, the European Semester needs to be as decentralised as possible so that the Member States take ownership of it. Some of this is already stated in the 2015 Annual Growth Survey, but I reiterate it:

- *From Community Enforcer to Enabler:* The Commission should become the Community 'Organizer' or 'Enabler' by overseeing a highly decentralised process in which national parliaments, NGOs, and social partners are a regular part of the 'National Semester.' One might pattern this on the 'Open Method of Coordination,' but most importantly it is the Member State that should 'transpose' the process into something that fits with national patterns of consultation.
- *The national level processes* should establish the major priorities for structural reforms, with the Commission providing advice and official statistical data, etc., to all parties involved.
- *Deliberations at the EU level* should ensure that the Commission itself is more 'democratic' internally, with greater involvement of

- other Directorates General (DGs) and openness to their contributions.
- *EU level processes* related to the European Semester should bring the European Parliament into the decision-making.
  - *Programme countries* should also be entitled to the flexibility that normal Member States benefit from within the European Semester — and be quit of the Troika.

### **3. Governing the Eurozone**

#### 3.1 Proposals for democratising the Eurozone

Decentralising in order to democratise the European Semester is not sufficient to ensure the effectiveness and legitimacy of Eurozone governance. Most importantly, EU Member States need to bring in the European Parliament into regular decision-making on Eurozone policy. For this, it would have to move back from intergovernmentalism to the Community Method. This change would ensure more political debate, and balance the outsized influence of individual Member States in the Council to some extent.

For the EP to be fully part of the process and the Community Method the main *modus operandi*, however, Treaty-based rules would need to become ordinary legislation, meaning that they would be open to amendment through political debates and compromise. Opt-outs for individual Member States would also be allowed, subject to denial by qualified majorities (Scharpf 2014b). The benefits would be many, but in particular we would see an end to the unanimity rule that imposes a lock-in via treaties, which once agreed cannot be undone because of the decision-trap of the unanimity rules. The UK sagely has the rule that one Parliament cannot bind the hands of the next. All democracies allow amendments to Constitutions by a supermajority (generally 2/3). Only the EU enables treaties to be unchangeable because of the unanimity rule. The Council has informally been attempting to get around this anyway, e.g., with the EFSF set up through multiple bilaterals and the Fiscal Compact agreed outside the treaties (to get around the UK veto).

The recent proposal for a special Eurozone Parliament, in contrast, is a bad idea, in particular because all Member States except two (UK and DK with opt-outs) are slated to become members at some point in the not too distant future. And how would such a Eurozone Parliament be chosen? From the existing EP? Or newly elected, to concentrate only on this? And at what level of abstention in voting could this body still be politically legitimate? Instead of setting up a Eurozone Parliament, special sessions of the EP could be set up for Eurozone questions, in which everyone has voice and can be heard, but votes are the purview of Eurozone members, assuming that the policies will affect them alone. That said, where policies affect others, and/or other Member States want to be a part of them, they too should be able to vote. It would be better to spend one's time figuring out how to revitalize the existing EP and make it better linked to the national parliaments, rather than to create another special body.

### 3.2 Rethinking European Union governance if Eurozone governance deepens

With proposals for greater deepening of economic integration, some have argued for a 'core Europe' in which a compact group of Member States agreeing to fiscal union would be surrounded by a larger circle constituted by a looser group united by the Single Market<sup>4</sup>. But this ignores the reality of what the EU is<sup>5</sup>. With the exception of the all-encompassing single market, the EU is essentially made up of clusters of Member States in overlapping policy communities with variable boundaries in terms of membership – not just the members of the Eurozone but Schengen (with the UK and Ireland out but Switzerland, Norway and Iceland in), Common Security and Defense Policy (Danish opt-out and all others opting in), and the Charter of Fundamental Rights (UK and Polish opt-out). Moreover, the number and variability of the EU's policy communities are likely only to increase over time as a result of enhanced cooperation in a range of areas, with 'regional

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4. These include the Glienicker group (2013), the Eiffel group (2014), the Future of Europe initiative (2012), and President Hollande (2013).

5. I like to call the EU a 'region-state,' as a regional union of Member State nations in which the creative tension between the supranational Union and its Member States ensures both ever-increasing regional integration and ever-continuing national differentiation (Schmidt 2006).

clusters' of Member States in areas such as security, energy, and immigration (Tocci 2014).

Creating a hard core around the Eurozone may make other potential community clusters more difficult to pull together, with the other clusters likely to be characterized by an increasingly high degree of differentiation without integration — already the case for transport, communications, and infrastructure — or even fragmentation and the risk of disintegration — in areas such as energy, the environment, migration, mobility, and asylum (ibid.). Moreover, given the differences among Member States on these issues, there is no guarantee that even a hard core around the Eurozone will expand to incorporate these other policy areas.

Imagining the Eurozone as the core disregards the effects of the Eurozone crisis, which has created an increasing division in economic identity constructions, in particular between Northern and Southern Europe but also more generally between inside and outside the Eurozone. It is unclear that a smaller hard core would be able to come to agreement more readily than the larger EU membership can. Moreover, creating such a hard core would be most likely to permanently alienate Member States who resist euro-membership, such as the UK, Denmark, and Sweden. And this would be likely to further the cause of 'Brexit' (British exit from the EU), if the UK were to feel itself fully marginalized from a significant role in EU governance.

In addition to these problems are further practical questions such as which Member States are to be included and which excluded, in particular if Member States to be left out might have capacities necessary for the core to succeed in another given area (e.g., Britain in defense and security policy; Sweden on the environment). Moreover, if all Member States are notionally to become members of the core at some later date (in particular if the Euro forms the 'core'), does it make sense to exclude them now? As it is, most Member States belong to some aspect of Eurozone governance. All Member States signed up to the SGP, the European Semester, and the 'Six-Pack' legislation (requiring all members above 60% debt to move toward compliance and be subject to the Macroeconomic Imbalance Procedure); all but the UK adhered to the Treaty on Stability, Coordination, and Governance (the so-called 'Fiscal Compact,' which reinforces the legislation above

by making it a treaty as well); 23 Member States joined the ‘Euro Plus Pact’ (17 Eurozone members plus Bulgaria, Denmark, Latvia, Lithuania, Poland, and Romania, focused on improving competitiveness, employment and fiscal consolidation); and 17 (Eurozone) Member States signed up for the ‘Two Pack’ (strengthening provisions of the European Semester and financing mechanisms such as the ESM and the EFSM) (Tocci 2014).

The EU, in short, cannot be made up of one ‘hard core.’ It does better to be understood as having many overlapping policy clusters, which through their overlap creates a *soft core* encompassing a large majority of Member States (Schmidt 2009). That soft core also includes the Eurozone.

But how, then, can we conceive of a reset of European economic governance within and beyond the Eurozone? How does the EU get beyond ‘governing by the rules’ and ‘ruling by the numbers?’ The reinterpretations of the rules that have already led to a more politicised Council, a potentially more autonomous and doubly accountable Commission, a more empowered EP, and an ECB acting akin to an LOLR suggest the beginning of the way beyond rules-based governance. The recommendations for more policies promoting economic and social solidarity would add to this. But more coordinated EU economic governance is also necessary. With a more decentralised European Semester, the existing EU-wide system of Member State budget development and oversight adds bottom-up processes to top-down ones. But the top-down processes could and should also be reformed. They need not remain stuck with the numbers-targeting rules.

Instead of speaking and/or acting as if the rules and numbers are set in stone, they should be understood as general guidelines — which is what they actually have become in practice. The specific targets could therefore be revised upward or downward in yearly budgetary discussions of what the EU economy as a whole requires for growth and prosperity. Such revisions have actually already started informally, with the shift away from the insistence on austerity to an insistence on growth and investment. But it could be formalized as a yearly exercise in which the Commission could make recommendations based on ECB forecasts of the needed inflation rate in consultation with the decentralised National Semester Councils of the Member States, to be

then deliberated in the Council — among Eurozone and non-Eurozone Member States alike — with the recommendations then considered in the EP in consultation with national parliaments. Such an EU-wide system of budgetary coordination would thus come closer to an EU-level economic governance in tune with the real needs of national and EU economies, responsive to changing realities and more open to the needs of European Member States' heterogeneous economies.

## **Conclusion: will this time really be different?**

The danger for the EU, given the Eurozone crisis that has been a catalyst for increasing polarisation in terms of politics and identity, is *differentiated disintegration*. The best remedy against this is for EU leaders to develop new visions of what the EU is and where it should go along with new political processes that bring citizens and parliaments back into policymaking at national and EU levels. This is particularly important for Eurozone governance, which has strayed from the EU's long-standing democratic settlement through an excess of intergovernmentalism and supranationalism. As for the European Semester, if it continues, it needs to be increasingly decentralised to ensure that greater flexibility comes with legitimating discourse. Beyond this, the EU needs to get Eurozone policy right in order to ensure better economic performance. And this means deepening economic integration in ways that substitute initiatives that provide real economic and social solidarity for the punitive rules and numbers. Unless EU and Eurozone Member States hang together, they will hang separately — with increasingly negative consequences for all, not just for Southern Europe.

So the question is, again: Will this time really be different? Can the EU change its policies, politics, and processes in such a way as to resolve the Eurozone crisis once and for all?

Much suggests that this is unlikely. Politically, public trust in national and EU institutions has fallen dramatically together with support for European economic integration while citizen dissatisfaction with national governments and disaffection from the EU has been on the rise. This trend has translated into increasingly volatile national politics. Populism has been growing, incumbent governments have increasingly been voted out of office, and extremist parties with anti-

euro and anti-EU messages have gained attention, votes, and even seats in both national parliaments and the EP.

The toxic politics have been fueled by the poor economic performance of the EU, and in particular of Eurozone members, along with increasing divergence between the export-rich surplus economies of Northern Europe and the rest. Eurozone policies focused on ‘governing by the rules and ruling by the numbers’ have not remedied the situation. Austerity budgets requiring rapid deficit and debt reduction accompanied by admonishments for ‘structural reform’ have not worked. Debt to GDP has risen in countries most at risk while growth remains elusive and poverty and inequality rise along with unemployment, jeopardizing political stability. And yet the EU has appeared unable to change course.

EU leaders seem locked into such policies by institutional logics that make formally changing the rules almost impossible so long as there is significant disagreement among the Member States about what to do and how to do it (in particular given the unanimity rule for revising treaties). The political logics have only reinforced such institutional gridlock, in particular when EU leaders are worried about electoral losses to the extremes on the right or the left. Moreover, having committed themselves to a course of action that has led to increasingly restrictive reinforcement of the rules, EU leaders have found it difficult to legitimate changing course, even when they are so inclined. The new bailout agreement in response to the current Greek crisis, moreover, with its harsh austerity terms imposed on and accepted by the radical left government, has seemed only to reinforced the coalition supporting governance by rules and numbers.

Finally, against this background, it is not surprising that there has been little political will or sufficient trust among the Member States to take steps to resolve the crisis once and for all. Suggestions for deeper economic integration focused on more positive remedies do come up for discussion periodically, such as the ones mentioned in this chapter, including some form of mutualisation of debt, different forms of social solidarity, proposals for investment strategies, or even harmonization of tax policies. But with the exception of a banking union (a big exception), they haven’t got very far.

For all of this, 2014 has been different: change is in the air. The public mood has been shifting. Even as the extremes have garnered more votes, public trust in EU institutions and national governments now shows an uptick, after precipitous declines since the beginning of the crisis<sup>6</sup>. This may be due at least in part to a sense that policies, politics, and processes may be changing for the better.

First of all, politics came back in. The EP campaign in particular drew attention to the political differences among party candidates through high profile debates and national campaigns. Some EU Member State leaders in the Council were also contesting the rules more openly and debating the merits of stability versus flexibility, while all were now calling attention to the need for growth. As for the policies, the Commission was being increasingly flexible in its interpretations of the rules, with more derogations on the numbers, while the ECB was taking further steps to solve the crisis, now through quantitative easing. And the newly elected Commission President pledged to establish an Investment Fund (European Council 2014) and to combat youth unemployment and poverty through targeted programmes.

Only time will tell whether the change in mood in 2014 will be followed by a change in the EU's economic prospects, with less volatile politics, more effective policies, and better governance processes. The Commission's ability to lead remains an open question, as does the willingness of the Council to allow it. Moreover, even though the EP elections have given EU citizens a more direct voice in EU governance in principle, the legitimacy derived from that voice is not assured in practice given the high rate of abstentionism in EP elections that also brought in a large extreme right contingent. Additionally, national politics have become increasingly unstable, as new challengers on the extremes have been gaining voice and votes. If the European economy were to remain in the doldrums, or to get worse, while the politics continues to be volatile and the policies seem ineffective, 2014 would still constitute a watershed year. This time would indeed be different, but as a turn to the worse rather than the better.

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6. Trust in EU institutions went from a high of 57% in spring 2007 down to a low of 31% in spring 2012, in 2013 and spring 2014, then jumped up to 37% in autumn 2014; trust in national governments went from a high of 43% in spring 2007 to 24% in autumn 2011 and a low of 23% in autumn 2013 then back up to 29% in autumn 2014. Eurobarometer EB 82 (2015).

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