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## The JCMS Annual Review Lecture The Shattering of Illusions – And What Next?\*

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### I. Ten Years of Fast Learning . . . the Hard Way

The European Union (EU) entered the new century on a wave of euro-enthusiasm. Many people were convinced that integration was running fast again, and the process would be unstoppable. Some went further, predicting that the 21st century would be the century of Europe, and many more were ready to believe them.<sup>1</sup> It was too good a prospect to dismiss lightly. For the fainthearted, and those with a more sceptical, or just narrowly utilitarian, approach to European integration, it was of course all rather threatening. They felt they were being swept aside. They were in a minority, not strong enough to resist the wave of euro-enthusiasm, but always alert to take advantage of any future change in the direction of the wind. And the opportunity eventually did come their way.

\* This article is dedicated to the memory of Tommaso Padoa-Schioppa, a leading European thinker and practitioner, who played a major role in the European construction and the creation of the euro in particular, and Susan Strange, a pioneer in the study of international political economy, who analysed the workings of casino capitalism and its internal explosive dynamics at an early stage. They both stood up against the intellectual orthodoxy of their time – what the French call *'la pensée unique'*. I should like to thank the editors of the Annual Review, Nathaniel Copsey and Tim Haughton, for their very useful comments; Nikos Koutsiaras for many constructive exchanges of ideas; Eleni Panagiotarea for research assistance; and numerous colleagues from whom I have learned so much in joint projects and discussions across Europe and beyond.

<sup>1</sup> Leonard (2005) and Rifkin (2004) are good examples.

The EU was meant to proceed on yet another combination of deepening and widening, even more ambitious this time than in the past. The creation of the single currency was, undoubtedly, the most important act of integration since the very beginning. It was daring in its economic significance and broader implications; it was based on the use of economic means for political ends, thus continuing an old tradition going back to the Schuman plan of 1950; and it was heavy with symbolism. This had been decided back in the early 1990s as part of a package deal that linked money to the redrawing of the map of Europe and German reunification, after the collapse of the Soviet empire. The more directly political part of the package was to follow some years later with the attempt to turn the founding European treaties into a constitution. What the advocates of political union had failed to deliver with the Maastricht, Amsterdam and Nice revisions of the treaties, they were determined to achieve this time round. Treaty revision as a never-ending process?

The conditions seemed to be more propitious this time round. The other big project of the first decade of the new century was further enlargement of the EU: much more ambitious than ever before in terms of numbers of candidates and the size of the *acquis*, as well as in terms of the economic distance between candidates and those already in, not to mention the differences in political culture and collective memory between old and new members. The southern enlargement of the 1980s had surely been difficult, but ultimately successful. The challenge of incorporating the newly liberated countries of central and eastern Europe, plus the two island states in the Mediterranean, looked even bigger by comparison.

### *Crash Landing of the European Constitution*

More than a decade later, we are surely much wiser – chastened by reality, one might say. The Constitutional Treaty – with the word ‘compromise’ written all over it, including the name – hit the rocks in the French and Dutch referendums of 2005 before it reached the lands of the usual suspects. As a result, some of the symbols that had caused offence to the non-believers were thrown overboard, while the text became more complex and even more unreadable before it was finally signed as the Treaty of Lisbon. From the noble aspiration to engage the European demos in the writing of Europe’s first post-national constitution, we were back again to marathon committee meetings with crafty lawyers and diplomats in search of the long-winded compromise that still (unavoidably?) characterizes the European process. The revamped treaty did not enjoy a smooth passage either, thanks to the Irish who were the only ones to be consulted in a referendum – and since they did not

vote the right way the first time, they were asked to do so again! After years of agony, the Treaty of Lisbon finally entered into force in December 2009.<sup>2</sup>

From beginning to end, the latest attempt at treaty revision had lasted eight years. The process proved traumatic for all concerned – not to be repeated again for a long time, politicians and diplomats involved in the process vowed. Apparently, they had not counted on the strong will of the German chancellor, operating under the sword of Damocles of her constitutional court in Karlsruhe. Only a few months later in 2010, the EU was to embark on yet another revision of the new treaty, though we were assured that this would be a small operation without much political fuss. It remains to be seen.

During those eight years, we all discovered that European citizens were no longer ready to give their leaders a *carte blanche* on the future of European integration. A yawning gap had opened between elected politicians and their electors on things European: parliamentary ratifications of the Lisbon Treaty (and its predecessor) were mostly comfortable, voted by large majorities, while referendum results revealed much unhappiness and also large amounts of ignorance on behalf of citizens. The elitist conspiracy of European integration, full of good intentions and with pretty remarkable results, had probably reached its limits. European political leaders were apparently good at getting their officials to negotiate complex compromise documents, but most proved singularly incapable of explaining the end products to their fellow citizens.

Europe runs the risk of becoming a victim of complexity in times when mass politics turns into populism and simple messages. There is surely a problem of communication, but this is not the only explanation. Has Europe finally hit against the hard rock of national and local identities – the European and the global being things that only small cosmopolitan elites can understand and identify with?

Political discourses remained predominantly national, and there was precious little effort, even less success, in incorporating a European narrative in them. It was also a time of growing inequalities and uncertainty in our societies, often perceived as being directly linked to the opening of frontiers and global financial markets. European integration became increasingly identified with globalization, and there was growing resistance, especially in the more dysfunctional national systems that could not adjust to a changing environment. There were losers in the process, real, potential or even

<sup>2</sup> There is a vast literature on the workings of the European Convention, the failed referendums and the travails of the intergovernmental conference that finally led to the Treaty of Lisbon. See Norman (2005); Taggart (2006); Moravcsik (2006); and Piris (2010), among others.

imaginary.<sup>3</sup> Most national politicians (and others) were too late in realizing the problem, not to mention trying to deal with it.

Others spoke about the legitimacy deficit<sup>4</sup> of the EU and its institutions, which is not the same as the democratic deficit that had been much talked about in the literature earlier. Eurobarometer surveys have been pointing to weaker popular support for integration, while the 2009 elections of the European Parliament (EP) registered a record low rate of participation, mixed with heavy doses of apathy during the campaign. As the powers of the EP kept growing from one treaty revision to the next, popular interest in it was apparently on the way down: an inverse relationship that most analysts had not predicted.

Ambitions had thus to be scaled down significantly – and this was painful. The constitutional ambition had produced a political crisis which threatened to paralyse the EU. But the collective sigh of relief that accompanied the setting into force of the Lisbon Treaty was soon followed by another shock when people heard the names of those appointed to fill the posts of President of the European Council and High Representative. Those two posts were after all the major novelty of the Treaty and many expectations had been invested in them. Was the shock (and the disappointment that went with it) justified because the names clearly lacked political glamour, or did it rather stem from false expectations about what Mr (and Ms) Europe might have been allowed to do or say on behalf of members always alert to keeping the strings tight?

No national politician apparently wants a European (high or less high) representative to be able to stop the traffic in Beijing and other capitals – and there would be absolutely no point in doing so, the seasoned observer of the European scene might add. Back to reality, so read the message. But for euro-enthusiasts it was like a crash landing. It will take some time before we can pronounce on the effects of the new Treaty and what the new appointees, together with national political leaders, will be willing (or able) to make of it.<sup>5</sup> And we may well end up with very different conclusions about Mr Herman Van Rompuy, the President of the European Council, and Baroness Ashton, the High Representative, respectively. Personal qualities will play a role here, as will the nature of the job, together with what Harold Macmillan<sup>6</sup> famously

<sup>3</sup> I talked about losers inside countries and how this was beginning to affect European integration back in 2003 (Tsoukalis, 2005 [2003]). For a recent, in-depth analysis, see Fligstein (2008). The creation of the European Globalization Adjustment Fund in 2006 was one modest attempt to deal with the problem (Tsoukalis, 2006). It proved to be completely ineffectual: the kind of symbolic gesture that European leaders often resort to, and later ends up like an empty shell.

<sup>4</sup> See, for example, various articles on the subject in Cramme (2009). See also Neyer (2010); Piret (2008); and Scharpf's (1999) classical work on input- and output-oriented legitimacy.

<sup>5</sup> For an early, albeit very provisional, attempt, see CEPS, Egmont and EPC (2010), and Dinan (this volume).

<sup>6</sup> Harold Macmillan was prime minister of the United Kingdom in 1957–64.

referred to as 'events, my dear boy, events'. After all, European treaties, like national constitutions, only set the parameters for decisions and policies; they do not determine the contents.

### *Enlargement and Saint Panteleimon*

There was no crisis as such with the big bang enlargement that brought ten new members in May 2004, and two more in January 2007. From 15 to 27: no small deal. The new members were much poorer than existing ones, most of them with relatively short experience of democratic institutions, while some were also novices in the exercise of statehood. Many observers argue that enlargement has been the most successful foreign policy of the Union, extending *Pax Europaeae* to some of the less privileged and unstable parts of the European continent. This may indeed be true: the best application of European soft power, or Europeanization at its best and most efficient.<sup>7</sup>

Alas, few things come free in today's world. Successive enlargements have had a negative effect on the internal cohesion of the EU – and the latest ones arguably even more so. Numbers also make a big difference. Councils of 12 or 15 still looked like a group. With 27, European councils of different denominations resemble a (mini-UN) conference. This is bound to affect the workings of those institutions. It also tends to encourage bigger countries to circumvent official channels of negotiation deemed to be too slow and tedious and with little correspondence to the distribution of power in the real world. The nature of the game has changed. This is a common secret in Brussels among the old hands, although not often expressed in public for the sake of political correctness.<sup>8</sup>

We have discovered in the process that some countries may not have been ready to join, and that the process of Europeanization, especially after accession, has narrow limits. Yet we should have known that from previous experience. With the economic crisis that followed, we later painfully discovered that economic convergence between the core and the periphery of the Union was not so much of an automatic process either. The crisis hit particularly badly the new members of the eastern periphery of the EU, especially the Baltic countries, as well as Romania and Bulgaria (Poland being a notable exception). They were soon followed by southern Europe, plus Ireland. Many

<sup>7</sup> The literature on Europeanization is rich and with a relatively long history. See, among others, Featherstone and Radaelli (2003).

<sup>8</sup> Various authors have tried to assess the effects of enlargement on EU decision-making and the functioning of the EU as a whole. Wallace (2007) and Zielonka (2007) remain among the best. As with many econometric studies, there is always the risk that the researcher measures things that can be measured and leaves out those that really count.

years of economic convergence were at least partly rolled back in a short space of time.

I am certainly not arguing here that the latest rounds of enlargement should not have taken place, although they could have been better prepared. The argument is rather that enlargement comes with a price: the nature and the internal operation of the EU have changed significantly and enlargement has been an important factor in this change. Those who have always preferred a loose, more intergovernmental EU may be happy with this development; if anything, they had always seen it as one of the advantages associated with enlargement.<sup>9</sup>

Now, there is precious little appetite to take more members in. Most of the official candidates are to be found in southeastern Europe. On the one hand, there is Turkey – a big country and a rising power in the region, big but also very different (Grigoriadis, 2008; Oniş, 2007; Oktem, 2011). On the other, there are the small countries of the Western Balkans – namely the successor states of Yugoslavia, plus Albania (Rupnik, 2009): with few exceptions, those countries still have some distance to travel before they become functional political and economic entities. The appetite (and capacity) to integrate them in the EU is not there. Croatia will most probably sneak in. What about the others? Only a few people still consider the EU as a modern incarnation of Saint Panteleimon, the all-merciful healer of all kinds of disease. The miracle of Europeanization has been cut down to size through experience.

There is, however, the other side of the argument, equally valid, which says that the EU door should be kept open to all European countries that fulfil the basic criteria for entry. Closing the door would be like denying a key part of the European project. Squeezed between those two sets of arguments, the Union is tempted to resort to the old habit of procrastination. Hopefully, it may also try to think out of the box, linking further enlargement to the reshaping of the European project while also inventing new intermediate stages between membership and non-membership, and not only of the virtual kind.

### *EMU as a Postmodern Construction*

Before the internal political crisis ended, associated with the adoption of the new (no longer constitutional) treaty, a new crisis had begun. The biggest financial crisis of the developed world soon turned into a European crisis.

<sup>9</sup> Vivien Schmidt (2009) wrote about the different discourses on Europe, and expectations associated with them, among member countries (and political families, one might add). Most of the new members belong to the group of pragmatists (usually translated in institutional and policy terms as minimalists), led by the United Kingdom.

Many people then discovered what a currency without a state really meant (Padoa-Schioppa, 2004). EMU (economic and monetary union) was indeed a highly ambitious and risky project. Economists have always been divided on the balance between pros and cons; the decision to proceed had been after all highly political. Several people have wondered all along whether Europe was ready for such a big jump, while others relied instead on the well-worn strategy of successive disequilibria leading to ever higher levels of integration. The construction designed at Maastricht reflected economic orthodoxy and the internal balance of power at the time of creation. True, it was itself unbalanced, but that was all that was politically feasible at the time.

Before the crisis, I used to compare EMU to a postmodern construction (Tsoukalis, 2005 [2003]) that defies the laws of gravity (and economics?). It did so successfully for more than ten years, and there were those who were lulled into believing that the good times would last forever. Alas, the laws of gravity finally began to take their revenge – and they did so with great force. The year 2010 became the year of the crisis of the eurozone.

## II. The Bursting of the Bubble and the Euro

The crisis began back in 2007 in an obscure segment of the American financial industry, the so-called 'sub-prime loans market'. European political leaders first thought it was of no concern to them; little did they know. It soon spread to what was the most globalized (and unregulated) sector of the world economy. To be precise, it became a crisis that affected the whole of the western financial system, and in their typically arrogant fashion, Americans and Europeans branded it as 'global'. It did not stop there either. The financial crisis quickly spilled over to the real economy, leading to negative rates of growth in Europe and North America that had not been experienced since the Great Depression. In some countries of the eastern periphery of Europe, the decline was in double-digit figures in a single year (Connolly and Copsey, 2011). And that was not the end of the story. As many national governments opened their purse in order to save banks and jobs in the real economy, markets were seized by panic when they saw sovereign debt rising fast. The previous run on banks was thus succeeded by a run on states.<sup>10</sup>

There were three main underlying factors in the big crisis that hit the eurozone in 2010. The first had to do with the rapid rise of sovereign debt in several member countries, largely although not exclusively, the result of states running big deficits to mitigate the effects of a crisis born out of a financial

<sup>10</sup> For a good analysis of the crisis and its broader economic, social and political effects from different perspectives, see Hemerijck *et al.* (2009). See also the special issue of *JCMS* (Hodson and Quaglia, 2009).

system that had previously run amok. The second was related to growing current account imbalances inside the eurozone, typically between the north and the south. And the third was about the perception, widely held in Wall Street and the City of London (although much less so in most European countries), that Europe had neither the instruments nor the political will to deal with the problem.

And then markets began to bet massively against the euro, leading those politically naïve and more easily excitable to think that the demise of the euro (and also the EU?) might not be very far off. They had never understood the political investment made in the euro, and there was of course more than an element of *Schadenfreude* among those who had never welcomed the creation of the European single currency, not to mention the closer political union that would probably have to follow.

Greece served as the catalyst for the crisis of the euro because it had the worst combination of three different deficits – namely a large budget deficit being added to an already huge debt, an unsustainable current account imbalance, and a deficit of credibility since Greek politicians had been repeatedly economical with the truth and flexible with the use of statistics (see also Featherstone, 2011). Greece was a big problem on its own; it was also perceived as a precursor of things to come and a test case of how other European countries and the EU would deal with the twin problem of sovereign debt and imbalances.

The perception proved right this time: the big rescue operation soon mounted by the EU, with the assistance of the IMF (International Monetary Fund), was indeed the precursor of a Europe-wide crisis mechanism and broader changes in the governance structures of the euro, while the programme of stabilization imposed on Greece by its lenders served as a test of political, economic and social endurance in the adjustment to a world after the bubble. Ireland soon followed, and Portugal too. One thing, however, is sure: we are nowhere near the end of a crisis causing different kinds of collateral damage. After all, the political and social consequences of financial crises usually follow with a time lag. In Europe, they do not respect national borders, and this is complicating matters further.

The crisis is the result of colossal failures in markets and institutions; it also marks a big failure for the economics profession. The efficient market hypothesis, resting on the behaviour of rational actors armed with perfect information, which had provided the intellectual basis for financial deregulation, was shown to bear little resemblance to real life financial markets in which greed and moral hazard met in an explosive mix, with the old herd instinct being added for extra effect. Financial power often translates into political power: there were too many instances of politicians being hijacked

by financial lobbies. And the academic profession was shown to be particularly prone to mainstream thinking – for some, attachment to mainstream thinking was also apparently related to pecuniary interest.<sup>11</sup>

Of course, the bursting of the bubble was not specifically related to Europe. It acquired though a strong European dimension because of the existence of the euro and the weakness of its governance structures. Market integration had raced far ahead of policy integration; with the crisis, there was an urgent need to catch up. Financial regulation was found to be hopelessly weak. The Stability and Growth Pact was inadequate from its very conception; it was weakened in the process and poorly implemented. Surveillance by European institutions was also found to be very poor, and there was no crisis mechanism at all when it was sorely needed: some people had feared that the existence of a crisis mechanism would add to moral hazard.

Sure, there was systemic failure, but there was also gross irresponsibility by those elected or appointed to guard the gates. Much of the Greek political class (and those who elected them) had been adding for years to an already very large public debt: clientelism was coupled with gross mismanagement, and the results were appalling. Sure, the party had been great fun as long as it lasted. But were Greek politicians more irresponsible than their Irish colleagues who allowed a small group of bankers to bankrupt the Irish economy? What about British politicians, including those of New Labour, who had led for years the crusade of financial liberalization and deregulation? As for German politicians (and regulators), were they blameless and hence morally justified in chastising the others? After all, German banks had been allowed to play a big role blowing into the bubble for years by translating German savings into loans to other countries. Most of those loans went to consumption and construction bubbles, while the competitiveness gap between the north and the south in Europe kept on increasing.

When the bubble finally did burst, several politicians in different countries, egged on by tabloids and eager to ride the wave of rising populism at home, engaged in the game of finger pointing and the exchange of insults and national stereotypes. They should have known better, given the fragile nature of the European construction. It was like throwing stones in a glasshouse.

<sup>11</sup> Padoa-Schioppa (2007) wrote that European financial supervision was neither super, nor did it have any vision. In *What Kind of Europe?* (Tsoukalis, 2005 [2003]), I wrote about the inherent instability of financial markets, the risk of systemic crisis in a deregulated environment, and raised the question about who will pay the costs when the crisis does eventually break out: the finance industry, consumers or taxpayers? Others, of course, expressed similar views: an old-fashioned minority allegedly unable to understand, among other things, what a huge difference sophisticated computer models made in the functioning of financial markets. Now we all do, although having drawn very different conclusions from the ones propagated by the economic orthodoxy at the time. In a remarkable piece of self-criticism, the independent evaluation office of the IMF (IEO, 2011) wrote about groupthink, intellectual capture and incomplete analytical approaches behind policies that had led to the crisis.

With exceptions, the European political class will not come out of the crisis with high marks. This is meant as an understatement: in fact, much of the political class in some countries risks being wiped out.

### III. New Economic Governance: Will It Work?

Crisis is the mother of change, and crises in the past have often provided the catalyst for further integration in Europe. The functionalist strategy seems to be back again and in full swing: we need to strengthen the 'E' in order to secure the 'M' of EMU. In other words, we need more effective institutions and rules of economic governance to safeguard the single currency. And this has been indeed happening in successive stages since European leaders admitted in the early months of 2010 that there was a collective problem that required collective action. It has been happening slowly and reluctantly, as is customary in EU affairs. In this particular case, the mental adjustment required was indeed huge and extremely painful at a time when the appetite for further integration is clearly lacking.

Having reached the edge of the precipice, European leaders have taken decisions that would have been completely unthinkable only a short time ago, thus so far disproving the Cassandras who had been betting on disintegration. We will end up with stronger and more effective governance structures, including new rules and institutions for the regulation of financial markets, closer and more binding co-ordination of national economic policies with a much broader agenda, backed up with the threat of (more or less) automatic sanctions and more effective surveillance procedures, greater emphasis on structural reform aiming at restoring the competitiveness of national economies that have been lagging behind, as well as a mechanism for crisis management on a permanent basis with large sums of money, strong conditionality and close IMF involvement in order to convince markets that European leaders mean business.<sup>12</sup> In the meantime, individual members, starting with Greece, followed by Ireland and Portugal, have been going through the purgatory of large-scale budgetary consolidation, accompanied by structural reforms, as a condition for the provision of financial assistance by the other members of the eurozone.

Will it work? The optimists point to the high stakes and remind us that when it comes to the crunch European leaders finally take the necessary decisions in order to save the integration project – the euro being

<sup>12</sup> There is a rapidly growing literature on the new European economic governance. For a good summary description, albeit unavoidably rather sterilized in political terms, see ECB (2011). For a cogently argued and critical paper on the subject, see also De Grauwe (2011).

undoubtedly a key part of it. The new governance structures will have to work, they add, and remaining gaps will be filled as we go along. The pessimists, however, point to the enormity of the challenge ahead and the big questions that still remain unanswered. Of course, the one trillion euro question is whether the crisis will stop there. Extending beyond those three countries of modest size, it would stress test the endurance of the new crisis mechanism. No doubt, we live in interesting times: for the Chinese, this is meant as a curse, not a wish – this is presumably also true for Europeans today. We have clearly reached a new integration frontier, and we are not at all sure what lies ahead. EMU looks like a make-or-break issue for Europe.

Co-ordination of policies is much easier said than implemented, and the political basis on which it rests remains shaky. We are all very much aware of the implementation gap in an EU so often forced to resort to long communiqués as a poor substitute for action. For example, the so-called ‘European semester’, which aims at a simultaneous assessment of national budgetary and structural measures, has a noble intention behind it. But how will national parliaments react, especially those of the bigger countries (we are surely all equal, but some are still more equal than others!), when they begin to receive more or less binding instructions from Brussels? Even more so, what will heads of state or government of the eurozone make of the collective ownership they have taken of the new Euro-plus Pact, which is meant to extend co-ordination to policy areas beyond those coming under the more constraining rules of the Treaty? The experience with the old Lisbon Agenda is hardly promising. Is it again the triumph of hope over experience?

Provisions for closer co-ordination of national economic policies do not automatically resolve the problem of who actually sets the priorities for the eurozone (and the EU as a whole), and how. To put it differently: how will the burden of adjustment be distributed between surplus and deficit countries, with direct implications for the general macroeconomic stance for the eurozone and the EU as a whole? In the long debate and negotiations on European monetary union that go back more than 40 years, the French have been persistently trying to ensure some symmetry between the two: judging from results, mostly in vain (Tsoukalis, 1997). This is an old problem acknowledged by Keynes during the Bretton Woods negotiations. At the time, the Americans represented the surplus countries, although not for very long.

Should fiscal consolidation in southern Europe (and elsewhere) be accompanied by measures to bolster domestic demand in surplus countries? And is there room for EU instruments, including a more flexible use of Structural

Funds, to promote investment and growth?<sup>13</sup> Germany plays the role of China in the eurozone with a large surplus in its current account. Much of this surplus is the counterpart of deficits in the south. Admittedly, the intra-European debate on the delicate matter of distributing the burden of adjustment has been more diplomatic and polite than the international one pitting the United States against China: for obvious reasons, we can guess. Yet, it has also been a political *bras de fer*, in which the view of the strongest, backed by markets, has so far prevailed.

Austerity may be indeed the right message after many years of excessive borrowing in Europe and the rest of the developed world. But austerity can go too far with the risk of Europe plunging into another recession. And what if prolonged budgetary austerity proves too much for the economies and societies of the European periphery? Structural reform is also fine, indeed urgent in some countries, but can, or should, all countries imitate the German model and try to keep wages down as a way of winning the competitiveness race? We usually discover the threshold of social tolerance once we have crossed it. Greece seems dangerously close to it.<sup>14</sup> The convergence machine of European integration is now going into reverse gear, with the less prosperous periphery being left behind. It is a threatening prospect and a dramatic reversal of earlier trends, if it were to continue for long.

The crisis began a few years ago with runs on banks and it has been followed by runs on states. Large bank exposure and rising sovereign debt have been operating like communicating vessels across national borders. In other words, there is a close interdependence between the banking and the sovereign crises in Europe.<sup>15</sup> They need to be tackled jointly in the transition to a post-bubble world. However, this raises in turn the awkward question of how to distribute the burden of adjustment between taxpayers and private lenders (or bondholders). Markets anticipate so-called 'haircuts' of sovereign debt of one or more of the most vulnerable countries in the foreseeable future; and this has added to the panic. It does not help that this issue has been

<sup>13</sup> The President of the European Commission, José Manuel Barroso, has proposed the issuing of Eurobonds for the financing of large investment projects in partnership between governments and the private sector. On the so-called 'project bonds', see Haug *et al.* (2011). There have also been proposals for the frontloading of money spent through EU Structural Funds as a way of boosting investment in the crisis-stricken countries (Marzinotto, 2011).

<sup>14</sup> The cases of Latvia or Lithuania, which have gone through an internal devaluation while experiencing a fall of 15–18 per cent of GDP in one year, have sometimes been presented as examples to follow. God protect us from the virtuous – and some economists too!

<sup>15</sup> See also Buiters *et al.* (2011); Darvas *et al.* (2011); Kopf (2011). Several people, including prominent politicians and analysts, have put forward proposals for the issuing of Eurobonds, partially replacing national sovereign bonds, as a way of restoring stability and confidence in financial markets (Juncker and Tremonti, 2010; Steinmeier and Steinbrück, 2010; Gros and Mayer, 2010). Such a move would constitute a first, big step towards fiscal union, considered by a good number of economists as an essential component of EMU. However, some of the key political players are not ready for it – at least not as yet.

formally raised in association with the establishment of a permanent crisis mechanism (European Stability Mechanism – ESM) in 2013. Trying to buy time while everybody knows that some of the most difficult decisions lie ahead does not help to calm the nerves. Is sovereign default an option, or even an inevitability, and with what consequences? Democracies and financial markets do not operate on the same clock. The lack of synchronization becomes highly destabilizing in a world where markets set the pace.

Honest stress tests for European banks will probably have to be followed in more than a few cases by recapitalization and restructuring. But who will then provide the invisible hand to guide them since there is no political authority in Europe to match a highly integrated banking sector? Recapitalization and restructuring of banks may have to precede any attempt to deal with the highly sensitive political question of how to distribute the burden of adjustment to a world after the bubble between taxpayers and private creditors. And this in turn overlaps with another difficult problem of distribution – namely the one between countries. In other words, who should pay for the toxic assets of European banks, being the product of excessive lending to both private and public sectors? Should it be taxpayers in Ireland, Greece, Germany or France? And how much should creditors or shareholders of those banks share the burden? Distributional issues are difficult to handle, even more so when they cross borders. This remains very much true of the EU, despite long years of integration. Such issues are now at the very top of the European political agenda.

Let us try another way of looking at the problem. Do German politicians, for example, find it politically easier to pay for the rescue of Greece or Ireland, painful though it may be domestically, than face squarely the problem of their own *Landesbanken*? This would be a fascinating question to address for political economists. The place that banks and the financial industry in general will (be allowed to) occupy in the brave new world after the crisis has not yet been settled. True, the enthusiasm for bold reforms seems to have dissipated rather rapidly. Is the next financial crisis an accident waiting to happen?

#### **IV. The Broader Picture**

The crisis has been international as well as European in its range, although the effects have varied significantly from one country to the other. There is now more economic divergence inside Europe because of the crisis, and the odds are that the divergence will continue, if not worsen, in the foreseeable future. Germany and the countries around it have entered a phase of economic

recovery, robust as it seems, while those in the south and the west of Europe (also Britain?) face the prospect of very slow growth, if not stagnation: fiscal retrenchment surely does not help.

In times of diverging economic performance, agreement on a common European approach, not to mention a comprehensive European solution, to the crisis is understandably difficult to reach. There are competing strategies between countries, mainly between creditors and debtors, but there are also competing strategies within countries. The intra-European negotiation is still predominantly intergovernmental, but there is also growing public debate on alternative strategies and policy choices that are no longer confined within national boundaries – and this is a very good sign for Europe.

Political leaders have to cope with growing dissatisfaction in their societies, which in places goes one step further and turns into anger and social unrest. Populism is on the rise and so are anti-establishment parties. They offer simple solutions for complex, yet real, problems, they love scapegoats, and they carry a strong nationalist message with often anti-European and generally xenophobic undertones. They have a strong presence in France, Austria and the Netherlands. Different versions can be found in Belgium and Italy. They are on the rise in several countries in Europe, even in what used to be social democratic Scandinavia, long perceived as being immune to that kind of problem. And some are pretty ugly. If populism were to obtain a political foothold in Germany, it could have wider consequences given the increasingly central role that Germany plays in the European system. Countries in central and eastern Europe are more familiar with populism: they have already experienced different versions of it in the transition to democracy and capitalism.<sup>16</sup> They may therefore have lessons to teach their fellow members of the European family, those with longer experience in parliamentary democracy but hardly any experience with cuts in living standards and social expenditure until very recently.

There is a host of factors behind the populist phenomenon, of different scale and combinations across European countries: large immigration, widening income disparities, growing uncertainty in times of rapid change, dissatisfaction with the 'Golden Straitjacket'<sup>17</sup> imposed on societies when Left and Right converged that may now get worse if the burden of adjustment after the crisis is perceived to be unfairly distributed. Unhappiness turns into social unrest in those countries where the problems are more acute, the culture of social protest is stronger and the institutions weaker. Financial markets

<sup>16</sup> For an interesting article on populism and different conceptions of nationalism in Europe, see Auer (2010). See also Deegan-Krause and Houghton (2009).

<sup>17</sup> A term introduced by Thomas Friedman (1999).

remain as imperfect as they have always been (and in panic), while national governments are increasingly constrained by their public opinion in seeking solutions which require a strong global and regional component for problems that have long ceased to be confined within national boundaries. It is like trying to navigate between Scylla and Charybdis. We know from Greek mythology that this required enormous skill and courage – qualities that are in short supply among political leaders in today's Europe.

National governments, of course, remain the key players, and public discourse is predominantly national. European public space is small, although growing and largely because of the crisis. True, those who try to intermediate between national discourses often lose themselves in translation. The EP was meant to gradually make the connection: some MEPs have succeeded in that respect, but most do not have much of an audience anywhere, while transnational political parties are still weak players. As for the Commission, steering a European course has become increasingly difficult in recent years, especially since political leaders in the big countries showed little interest in or respect for it. The European Commission might try instead to be more assertive. The one institution that comes much stronger out of the crisis is surely the ECB (European Central Bank). Even diehards of national sovereignty recognize the crucial role it has played in managing the crisis – and we were surely lucky to have Mr Trichet<sup>18</sup> at the helm when the going got really rough. The ECB is a federal institution par excellence. It also follows the venerable tradition of depoliticized policies at the European level: independent central banking at its best. Rightly or wrongly, it is not an example that can be widely imitated or transplanted.

One is tempted to argue that the European political system is turning more intergovernmental, with the European Council being the place where the buck stops. This is certainly true of negotiations leading to the provision of financial assistance to the heavily indebted countries of the eurozone and the European Financial Stability Facility (EFSF), which will be replaced by the European Stability Mechanism (ESM) in 2013. But can a purely intergovernmental system deliver the goods? This is one question that Ms Merkel and Mr Sarkozy have been trying to evade. European economic governance requires collective ownership and institutions that can provide continuity, surveillance and implementation control. Intergovernmental arrangements cannot do that. It is interesting that by calling for more automatic sanctions in the context of a reformed Stability and Growth Pact, member governments will have to accept, albeit reluctantly, a bigger role for the European Commission. This is

<sup>18</sup> See last year's JCMS Annual Review (Trichet, 2010).

precisely what the 'reverse majority voting' rule for the application of sanctions should lead to – not what some member governments originally had in mind.

The crisis has placed Germany at centre stage as the country with the biggest and strongest economy in Europe, the indispensable country in any European comprehensive solution to the crisis, and hence the one that can also dictate the terms (see Paterson, this volume). Many years back, it was monetary policy and exchange rates that had led to the first concrete manifestation of a two-tier Europe, with West Germany leading the first tier. It was in the mid-1970s, when the 'snake' was gradually reduced to a Deutschmark zone (Tsoukalis, 1977). Almost 40 years later with the euro, Germany is again leading the pack.

With the advent of the crisis in the eurozone, leadership was indeed thrust upon Germany. When this happened, its political leaders showed little enthusiasm for taking it on, or any signs of knowing what to do with it. As Germany gradually began to exercise leadership, also setting its own terms and conditions, many of its partners became manifestly unhappy. We were told that Germany had become a normal European country in which EU matters were now seen through the lenses of narrowly defined, short-term national interest. After all, others were behaving so, why not the Germans? Admittedly, many Germans were in a state of shock: the crisis of the euro had confirmed their worst fears about sharing a currency with countries that did not share their approach to public finance and many other things – and their view of European integration, understandably perhaps, turned grey. Some began to think of the EU, and especially its weaker members, as an albatross hanging from their neck that they would much prefer to get rid of, others felt that Germany may be ready to go global on its own, while tabloids stoked the fires of populism.<sup>19</sup> Europe surely cannot afford a Eurosceptical Germany, but nor can it accept a hegemonic one. There should be enough space in between the two for a unified Germany playing a leading role in transforming European integration once again into a positive-sum game.

Franco–German initiatives continue to be a frequent feature of European decision-making: increasingly to disguise German strength and French weakness, the cynical observer might add. The relationship is indeed becoming

<sup>19</sup> There has been intense debate inside Germany about ways of dealing with the crisis, as well as about the pros and cons of bail-outs (a dirty word in German). As would have been expected in any country, the arguments ranged all the way from the sophisticated to the vulgar, from the European to the narrow nationalist. Many spoke of punishment, fewer of forgiveness. For an informative discussion about new Germany and Europe, see Guérot and Leonard (2011); and Paterson (this volume). For representative, yet different, views on ways to handle the sovereign debt crisis, see Belke (2010) and Bofinger (2010). See also the position paper signed by over 180 German economists against further rescue packages (Lucke, 2011).

more unequal, at least in economic terms, although it continues to leave a strong imprint on EU decisions and policies, with the rest often voicing their frustration. The main problem does not always lie with the content of Franco–German initiatives as such. Sometimes, it is the arrogance and sheer lack of diplomatic tact accompanying those initiatives that the other members have found most insulting. The recent ‘Pact for Competitiveness’, subsequently renamed the ‘Euro-plus Pact’ as a kind of verbal massage for the national sensitivities of lesser mortals, is a typical example – and not the only one.

Several people in Britain and Poland in particular have voiced their concern as the management of the euro begins to dominate European debate and policy-making because it risks marginalizing the countries outside the eurozone.<sup>20</sup> They raise the spectre of another kind of two-speed Europe, between the ‘ins’ and the ‘outs’ of the eurozone, which has been in fact on the cards since Maastricht. Monetary union remains the most important act of integration. It necessitates policy action and co-ordination on behalf of those who share the common good of a single currency that simply does not compare with what is required for the management of the single market. Those outside the eurozone have indeed legitimate views and interests which should be taken into account, but they cannot have an equal say in the decision-making related to the management of the euro. It is both logical and unavoidable.

In the years before the crisis, the EU had become increasingly identified with economic liberalization, hence running the risk of being delegitimized in the eyes of those who found themselves on the losing side of economic change. Parties of the centre-left became very much aware of this problem. Now, the perception is changing, although the political balance sheet may turn more negative. In the north, the spectre of a European ‘transfer union’ is haunting people: the bail-out of the bankrupt economies of their weaker partners requires ever increasing amounts of financial assistance and guarantees provided by Germany, Austria, the Netherlands and Finland among others; and their citizens (and taxpayers) are manifestly unhappy. On the receiving end of those transfers, which are in effect interest-bearing loans as long as they are being serviced, there are people who go through a long and painful process of budgetary consolidation and who increasingly perceive the EU as the policeman of austerity. The combination could be political suicide for Europe.

<sup>20</sup> The Prime Minister of Poland, Mr Tusk, expressed his concern in public. *The Economist* (2011) had a leading article in which it argued in strong terms against the emergence of a two-speed Europe as a result of measures to strengthen the governance of the euro; it was not, however, clear at all what it proposed instead.

## V. What Kind of Europe?

Some years back, I argued that the key question in European integration had long ceased to be '*How much Europe?*' and should be replaced by '*What kind of Europe?*' Different conceptions about the kind of Europe, and the kind of society in which we want to live, were hidden behind the question of more or less integration. There were trade-offs and choices to be made that the still predominantly intergovernmental political system of the EU failed to highlight (Tsoukalis, 2005 [2003]). I believe that this argument holds even more true today.

The biggest financial and economic crisis of the western world since the Great Depression may be the end of an era marked by economic liberalization during which financial markets acted as the spearhead of globalization, an era of rapidly growing consumption paid largely through rising debt and with deleterious effects on the global environment. The financial crisis and global warming are in effect the products of the two biggest market failures of the last two decades or so. Unregulated financial markets caused huge damage to the real economy. Similarly, markets in goods and services have failed to internalize the negative effects on the environment.

If this is indeed the end of an era, we are not yet sure what will succeed it.<sup>21</sup> We are still fumbling in the dark, trying to cope with the damage created by the bursting of a big bubble. The political vacuum created by the collapse of neo-liberal ideology has not been filled as yet; if anything, it tends to be filled by populism. And this has major implications for national as well as European politics and policy-making. It would be dangerously naïve to think that the European dimension of the crisis can be dealt with independently from the rest.

Many people pretend, and have good reasons for it, that the crisis was an unfortunate accident of the kind that can happen all the time ('stuff happens', as Donald Rumsfeld would have said). We should therefore deal with the damage as well as we can and go back to life as usual, they say. After all, there are vested interests to defend, as well as intellectual idleness and well-worn habits to contend with. Against mainstream opinion, there are those, still in a minority, who argue for a radical change in our way of thinking and the way we manage our national and European affairs. This change will have to include the redrawing of boundaries between the state and the market, the taming of the financial beast (an end to casino capitalism,<sup>22</sup> if you prefer), the

<sup>21</sup> In last year's Annual Review Lecture, Nicolaïdis (2010) talks of a 'Tocquevillian moment', in which a doomed era is ending without being replaced by the benefits of a new one.

<sup>22</sup> Back in 1986, Susan Strange began her last book with the sentence '[T]he Western financial system is rapidly coming to resemble nothing as much as a vast casino' (Strange, 1986, p. 1). She then proceeded to

adoption of a new approach to economic development that no longer upsets the planetary balance, and greater emphasis on equity and the quality of life instead of a one-dimensional focus on quantitative growth.<sup>23</sup>

Surely, our economies need to become more dynamic – the economic prospects do not look good and the demographic trends are even worse. Yet economic dynamism needs to be combined with a more qualitative and socially inclusive approach to economic development, thus creating the conditions for a new social contract that would cater more for the interests of the economically weaker, as well as the interests of younger generations who are now expected to foot our bill. European welfare systems surely need to be reformed, but in order to better preserve their essential features in changing conditions. After all, it is not the European social model in its different national incarnations that has brought Europe close to bankruptcy, but rather a particular variety of capitalism that had been advertised for years as the only way forward.

Europe is better qualified than other parts of the world to adopt such new ways of thinking and eventually even providing a model for others to follow. It has democratic traditions with strong roots, deeply ingrained notions of social justice and environmental concern, a long history of a mixed economy, and a healthy scepticism (of the large majority so far) of so many ‘-isms’, including crude forms of nationalism, a scepticism earned through bitter experience. Elsewhere, I have tried to translate the more widely accepted etymological explanation of the word ‘Europe’, meaning ‘broad eyes’ in Greek, into a rallying cry for Europe the broad-minded (Tsoukalis, 2011).

For a long time, European integration had been like a car moving uphill: the French usually provided the driver, the Commission the map, the Germans paid for the petrol and the British oiled the brakes. In more recent years, it looked like a car without a driver, the map was replaced by a GPS, going on and off, the Poles insisted on taking an insurance policy with God, nobody wanted to pay for the petrol (and some clearly cheated), while those inside had an argument about how many more could fit into the car.

The European political scene has become more pluralistic, with a wide range of opinions and interests. The interplay of national interests has always determined the course of European integration, the famous Community

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explain that the new system was both unstable and uncontrolled. It took most people many years to realize this fundamental truth about the new financial system. Today, critiques of the old order do not always stem from the same analytical or ideological basis, nor do they end up with the same, or even similar, policy conclusions. See, for example, two excellent works by Hutton (2010), with the emphasis on inequality, and Kaletsky (2010), who criticizes excessive faith in the efficiency of markets.

<sup>23</sup> See the report submitted to the president of the French Republic by a group of eminent, yet unorthodox, economists, including Joseph Stiglitz, Amartya Sen and Jean-Paul Fitoussi (Stiglitz *et al.*, 2009).

method notwithstanding. Yet as integration deepened and widened, national interest became more relative as a concept, and more directly shaped by partisan preferences. Other interests have begun to raise their pretty or ugly heads. There is no single European narrative,<sup>24</sup> as constructivists would have said. If it ever existed, it has surely suffered several deaths as a result of successive rounds of widening and deepening. And that is not necessarily a bad thing, just another sign of the European political system becoming more pluralistic and hence more mature.

Europe needs political oxygen to breathe. Otherwise, it may suffocate, or die from boredom.<sup>25</sup> True, interminable council meetings conducted through interpreters in search of the long-winded compromise is not the stuff that is likely to attract the old-style politician full of adrenalin. The nature of European politics is indeed different, but no less real. It often looks dull and introverted; there is something stale in the European world of Brussels. But we also know from experience that a few personalities can make a big difference, and we desperately need them today. Politics is about choices, and choices need to be clearly articulated and explained to citizens. In our European countries today, political choices must have a strong European component. Our security and prosperity depend on it.

There is a role for individual countries and for European institutions to play in giving concrete form and shape to the new era. The division of labour between the nation-state and the EU needs to be protected both from the missionary zeal of bureaucrats and judges keen on bulldozing all kinds of national particularities and idiosyncrasies in the name of the four fundamental freedoms of the treaties, but also from the illusions propagated by 'sovereignists' in a highly interdependent, congested and pretty small, yet highly diverse, continent. There should be enough room for differentiation in order to cater for internal divergence, as well as flexibility for those who may want to stay (temporarily?) out of common policies. And more emphasis should be placed on policy innovation and measures that work in a complementary fashion with those at national and local level.

In some policy areas, however, Europe will require more, not less, co-ordination and integration. Financial markets are a prominent example because interdependence in the marketplace has already gone very far. Interdependence needs joint management, and this has to be explained to people: there is an educational role for politicians as well. The same applies to the environment, the governance of the euro and also parts of the internal market. Can we seriously argue, for example, that in a single market with free

<sup>24</sup> On Europe's narrative diversity, see Pélabay *et al.* (2010).

<sup>25</sup> Politicization in the EU remains, of course, a controversial subject. Hix (2008) has strongly argued in favour, and I have also done so (Tsoukalis, 2005 [2003], 2007). Moravcsik (2006) thinks otherwise.

movement of goods and capital there is no need for co-ordination in the area of taxation, including corporate taxes? Unless, of course, we imply that taxes do not matter, or that free-riding should be elevated into a high principle of the integration project. There is no need for harmonized taxes, only for minimum rates that would put a floor underneath what now looks like a race to the bottom.<sup>26</sup>

Solidarity should remain an integral part of the overall European bargain, but it needs to be explained and defended against all kinds of populists and narrow nationalists. It also needs to be connected to common projects and common goods, in which most if not all see tangible benefits for themselves; and it has to be subject to conditions and rules.<sup>27</sup> No free lunch, in other words. This surely applies to the governance of the euro, and it should increasingly apply to immigration and free internal borders. Solidarity does not enjoy ample space in our increasingly atomized societies – and this is only more true across borders. We shall need to rediscover the meaning of society and the value of public goods in the years to come, thus partly reversing a trend that has lasted for too long and has gone too far.<sup>28</sup>

In his valedictory message, Tony Judt (2010, p. 225), one of the best minds of our time, wrote: ‘Social democracy does not represent an ideal future; it does not even represent the ideal past. But among the options available to us today, it is better than anything else to hand’. This may indeed be true, but judging from the state of social democracy in Europe today, the staleness of the message and the defensive, almost apologetic, stance of its official representatives, we will have to go further. Social democracy needs to reinvent itself; and it will surely have to acquire again a strong European and global dimension.

### *The Neighbours and the World Further Afield*

No word has been mentioned so far about Europe’s global role, or European soft power, with the exception of enlargement as a form of foreign policy that eventually transforms itself into internal policy. The cynical explanation would be that there is little to say given experience. Alas, the gap between expectations and official promises on the one hand, delivery on the other, remains wide. Trying to forge unity out of 27 independent-minded foreign

<sup>26</sup> This is an argument put forward by Mario Monti in his report to the President of the European Commission (Monti, 2010), as part of a new European bargain for the relaunching of the internal market programme.

<sup>27</sup> Jacques Delors has repeatedly and convincingly argued the case for solidarity as a key part of the European bargain.

<sup>28</sup> In Margaret Thatcher’s famous words: ‘[T]here is no such thing as society, there are only individual men and women, and there are families’ (*Women’s Own Magazine*, 31 October 1987).

chancelleries is, admittedly, no simple matter. You cannot undo history and geography in one stroke. Yet there has been a shattering of illusions in that area too in recent years. Europeans have often tended to confuse rhetoric with soft power, while on the big issues of war and peace Europeans have been too complacent, too weak or divided, to be able to influence events outside their borders. The world is indeed becoming multipolar, but Europe does not necessarily represent one of those poles (see also Howorth, 2011; Vasconcelos, 2010; Tsoukalis *et al.*, 2009; Smith, 2009).

Foreign policy normally starts with the neighbours, and Europe's Mediterranean neighbourhood, for example, has a long history of grand initiatives that have tended to fall flat on their face. Here again, ambition has not been matched by the policy instruments available. There have been contradictory goals and plenty of hypocrisy as well. The Europeans have for long followed the Americans in pretending to believe there is a real peace process on the Israeli–Palestinian conflict, while Israel was creating new 'facts on the ground' almost every day. The Europeans were not able, or they did not dare, to take a stronger and united stance. They have also pretended for long they had 'shared values' with all kinds of autocracies in the Arab world. Brussels was trying to export democracy and human rights through trade and aid, while individual member countries were supporting the local dictators: the soft power of the EU as a fig leaf? The new Arab revolt has forcefully removed it, while sweeping away any illusions entertained about the benevolent role and influence of Europeans in this highly unstable part of their neighbourhood. They are now trying to pick up the pieces and find ways of getting back on the scene (Vasconcelos, 2011).

In the next few years, the key challenge for Europeans will be to identify and collectively defend common interests and values in a rapidly changing world where size still matters a great deal. A divided, ageing and shrinking Europe would unavoidably court with strategic irrelevance and decline, and the signs are already there. 'Speak European' and 'Help Change the World in Your Own Image', so should read the message (Tsoukalis, 2011). In other words, speak with one voice (preferably also having something to say), back your words with action (this being surely more difficult), and use your own experience in promoting co-operation and collective management at the global level. It would be in Europe's interest to do so; a world of power politics and martial arts offers a very grim prospect for Europeans. And this is a mission that could mobilize many people on the old continent of Europe, especially the younger generations: another manifestation of Europe the broad-minded.

Will it happen? Honestly, the chances are not good. Decline may be indeed an irreversible trend in Europe; and if so, it may not necessarily happen with

much grace or even internal peace. The stakes are high. We risk losing some of the things we used to take for granted after many years of integration in Europe. A new political message for our societies requires a strong, yet realistic, European component. Will there be political forces that dare to articulate such a message and try to get it across with confidence and determination against the forces of inertia here and the rising populist tide there? Hopefully, we shall not have to wait for too long.

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