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The New Governance of the Economic and Monetary Union: Adapted Institutions and Innovative Instruments

Tobias Kunstein and Wolfgang Wessels

"The Political Future of the Union" Paper

Abstract

Reforms in response to the multiple crises affecting the European Union (EU) and the euro area since 2008 have transformed European governance considerably. This paper provides an overview of the main effects stemming from the introduction of innovative instruments over the past few years. It concludes that the evolution of the EU's architecture towards "more Europe" rooted in power-sharing between institutions at both European and national levels is likely to be complemented by "less Europe" in the sense of increasingly differentiated forms of integration.

Keywords: *European Union / Euro area / Financial crisis / Economic governance / Institutional balance*

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The New Governance of the Economic and Monetary Union: Adapted Institutions and Innovative Instruments

by Tobias Kunstein and Wolfgang Wessels[*]

1. Introduction: Three overlapping effects of the crisis on governance

Reforms in response to the multiple crises affecting the European Union (EU) and the euro area since 2008 have transformed European governance considerably. By tracing the trend towards more differentiated forms of European integration back to a number of innovative instruments introduced over the past years, this paper outlines some of the major determinants of the future development of the EU polity.

Three - partly overlapping - effects of the crises on European governance can be distinguished. The first two concern serious shifts in the institutional balance. The third effect, of a more structural nature, points to more differentiated, multi-speed and multi-tier integration within the European construction.

1) The European Council as the only "political" institution commanding the authority to pledge huge amounts of money has increasingly extended its activities into the EU legislative process.[1] Consequentially, adherents to the "intergovernmentalist" school of thought see their interpretation of the European Council as a dominant player in the complex inter-institutional relationship at EU level confirmed. From this perspective, the Heads of State or Government can be seen as the principals in relation to other actors in the EU's institutional structure along the lines of a "presidency model" (see Figure 1).

2) However, in parallel, the parliamentary dimension (the European Parliament and its national counterparts), already strengthened through the Lisbon Treaty, has become more relevant, although increasingly complex. On the one hand, when pressured by the financial turmoil to pursue increasingly unorthodox emergency measures, EU decision-makers sought to ensure that their response was backed by broad support from all EU-level institutions, including the European Parliament. National legislatures, on the other hand, played a major part in a number of cases in view of the history-making character of some measures and the high sums at stake. For example, votes on the ratification of the European Stability Mechanism (ESM) and the Treaty on Stability, Coordination and Governance (TSCG) in the German Bundestag and

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Paper prepared within the framework of the IAI project "The Political Future of the Union", January 2013. The project aims to examine the multifaceted responses given by the EU to the eurozone debt's crisis and the political and institutional issues linked to that, like the democratic control of the new governance of the Economic and Monetary Union. The project also aims to explore the options for the future of European integration and the transnational debates on this topic.

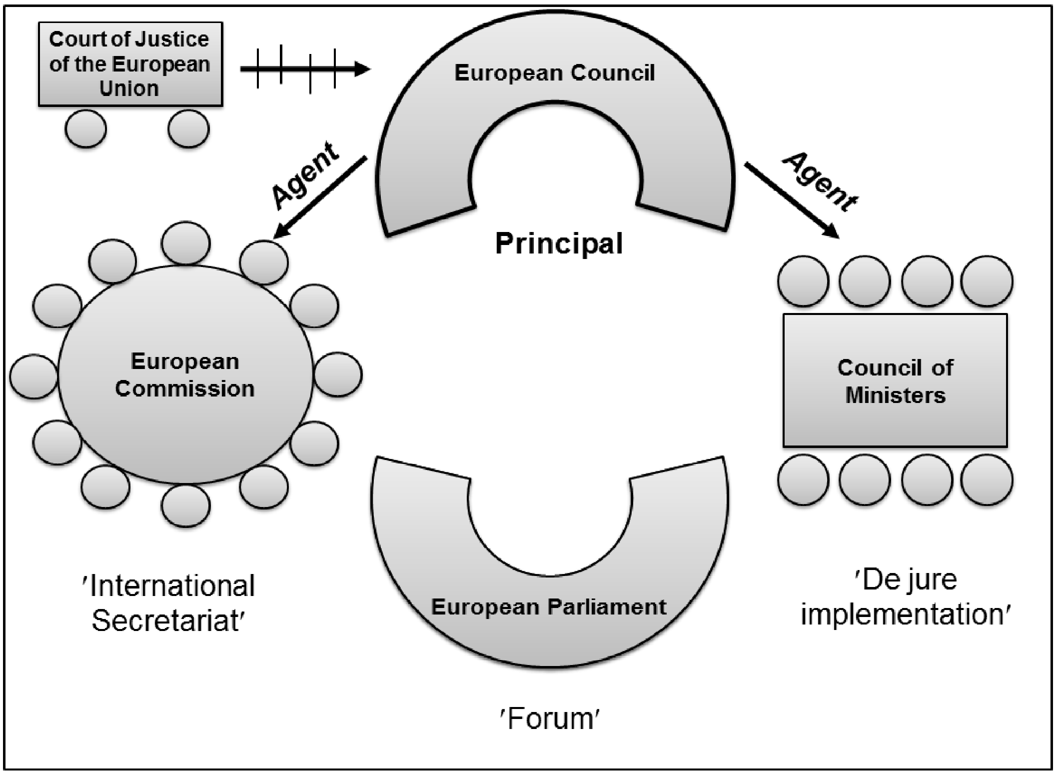
[*] Wolfgang Wessels is Jean Monnet Chairholder for Political Science, University of Cologne. Tobias Kunstein is Research associate, Jean Monnet Chair for Political Science, University of Cologne.

[1] See Uwe Puetter, "Europe's deliberative intergovernmentalism: the role of the Council and European Council in EU economic governance", in *Journal of European Public Policy*, Vol. 19, No. 2 (March 2012), p. 171.

Bundesrat received a degree of public attention rarely observed in EU matters so far. The Greek assembly also stood at the centre of attention, if for opposite reasons: its agreement to the reform programme negotiated with international lenders was a prerequisite for the bailout.

3) Beyond the crisis, in consolidating the governance architecture of Economic and Monetary Union (EMU), the longer-term concern of shaping the EU polity in an open and legitimate way has come to the fore. The concept of a multi-tier Europe - giving the core group of (euro) states the opportunity to move forward - is a key aspect of such considerations, and is reflected in major European Council agreements on crisis management measures and efforts to make the euro area and the EU more resilient to future crises. The flexibility offered by institutional constructions that do not include all EU member states attempts to reconcile the integrity of EU-level policies such as the single market, with the necessity to preserve the opportunity for outsiders to join at a later stage.

Figure 1. The European Council in the "presidency model"



Source: Wolfgang Wessels, The *European Council*, Oxford and New York, Palgrave Macmillan, 2013 forthcoming.

2. The crisis response: a broad differentiated set of instruments

Since the beginning of the global financial crisis, which peaked with the Lehmann Brothers bankruptcy in September 2008, EU decision-makers have introduced reforms going far beyond the conventional economic concepts discussed during the first decade of EMU. Considering the impact of these reforms, one needs to underline that what seems unavoidable now was quite unthinkable four years ago. The reforms can be broadly categorized into projects implemented within the EU treaties framework, and projects of "differentiated integration" implemented outside the EU treaties and by a subset of EU member states only.

Reforms building on the EU treaties and using the "Community method" include a number of key projects:

1) In reaction to the global financial crisis, supervision of financial markets has been overhauled, primarily by creating the European Systemic Risk Board (ESRB) and the European System of Financial Supervisors (ESFS) in 2010. These reforms, enacted through the "ordinary legislative procedure" (OLP), were most recently taken further when the European Council in summer 2012 called on the European Commission to present a legislative proposal on a pan-European supervision of banks (Single Supervisory Mechanism, SSM).[2] Following disputes, especially between France and Germany, on the number of banks to be overseen,[3] the legislation as proposed by the Commission is currently under discussion by the Council and the European Parliament in accordance with the OLP.
2) In December 2011, the Six-Pack of legislative proposals addressing the area of fiscal and macroeconomic surveillance and coordination came into force. It aimed at strengthening the fiscal coordination under the Stability and Growth Pact (SGP) and complemented it with a new procedure for preventing macroeconomic imbalances. The Six-Pack, the rules of which are partly based on coercion through sanctions (that is, "hard" coordination) also incorporated the "soft" coordination instrument of the "European Semester", an annual timetable for economic policy coordination already agreed upon by EU governments in 2010. Two additional legislative proposals ("Two-pack"), which build on and tighten the rules of the Six-Pack legislation for the 17 euro area members, are currently under negotiation between the Council and the European Parliament in accordance with the OLP.
3) The institutional governance framework has also been transformed due to the crisis. Notably, the Heads of State or Government of the euro area meet among themselves in a new format, the Euro Summit. The agreement in October 2011 to hold these meetings at least every six months and to equip the Euro Summit with a more formal preparatory substructure attests to the general tendency of the EU system to resort to forms of differentiation. The concepts of a "multi-tier", "core Europe" or "two-speed Europe"[4] have thus become key issues for the development of the EU polity.

[2] According to the proposal, the European Central Bank (ECB) would receive responsibility for supervisory tasks related to the financial stability of all euro area banks. In order to avoid fragmentation of the internal market for financial services, the existing supervisory structures under the ESFS which apply to all 27 member states would be preserved, and member states outside the euro area would be invited to join the SSM on a voluntary basis.

[3] The French proposal that supervision would eventually include all 6000 or so banks in the euro area basically prevailed in the end.

[4] See e.g. Jean-Claude Piris, *The Future of Europe. Towards a Two-Speed EU?*, Cambridge, Cambridge University Press, 2012; Funda Tekin, *Differentiated integration at Work. The Institutionalisation and Implementation of Opt-Outs from European Integration in the Area of Freedom, Security and Justice*, Baden-Baden, Nomos, 2012.

But steps towards more differentiated integration are especially visible in that a number of additional reforms were possible only outside the treaty framework.

In response to the imminent threat of the break-up of the currency bloc in the first half of 2010, euro area countries developed an internal crisis resolution mechanism available to themselves alone. "Money" itself became a key instrument, at first in the form of the European Financial Stability Facility (EFSF), a temporary "firewall" established to provide liquidity to over-indebted countries. Its successor, the ESM, is built on a limited change in the EU treaties,[5] enabling the euro area countries to establish a permanent rescue mechanism among themselves by means of an intergovernmental treaty. The ESM entered into force in October 2012.

The Euro-plus Pact, created in March 2011 to improve the competitiveness of participating countries, includes a larger number of countries (all euro area members, plus Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania). However, given that it relies exclusively on voluntary adherence to its rules - "soft" coordination - and that there are no plans to incorporate the pact into the legal framework of the EU, its impact is expected to be rather low.

Another intergovernmental agreement outside EU law is the TSCG. Negotiated among euro area member states after the sovereign debt crisis had intensified anew in late 2011, the treaty aims at further strengthening fiscal discipline at the national level. At the time of writing, all EU members except the United Kingdom and the Czech Republic have signed the TSCG, ratification of which is a precondition for receiving ESM assistance as of March 2013. In substance, the TSCG contains a proper "fiscal compact", which will run alongside the Six-Pack. *Inter alia*, the fiscal compact requires national budgets to be in balance or in surplus, and introduces rules specifying an automatic correction mechanism to that effect. These rules must be implemented in national law through provisions of "binding force and permanent character, preferably constitutional",[6] subject to legal review by the European Court of Justice (ECJ).[7]

3. The institutional balance: rivals and partners

3.1. The European Council and the Council: managing the crisis

Throughout the financial and sovereign debt crisis, the Heads of State or Government have been engaged in both system-making and policy-making. Their role can be described as an "upgraded and intensified leadership role"[8] which spans five pillars of economic governance (Figure 2). Besides their guiding function in the revision of the procedures of hard and soft coordination and in the reforms based on the Community

[5] Article 136 of the Treaty on the Functioning of the European Union (TFEU), http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:115:0047:0199:en:PDF.
[6] Article 3(2) of the TSCG, http://european-council.europa.eu/media/639235/st00tscg26_en12.pdf.
[7] Moreover, the fiscal compact enshrines a numerical benchmark for debt reduction for government debt exceeding 60% of GDP and increases the automaticity of the excessive deficit procedure under the SGP. The TSCG also calls for *ex ante* reporting by member states of their national debt issuance plans.
[8] Wolfgang Wessels, *The European Council*, Oxford and New York, Palgrave Macmillan, 2013 forthcoming.

method, the Heads of State or Government also have a major role in settling fundamental issues in negotiations on the EU budget.

Figure 2. The European Council in the institutional architecture of economic governance: five pillars

Policy domain	**Monetary Union**	**Fiscal Policy**	**Economic, Employment and Social Policies**	**Internal Market and accompanying policies**	**Budget**
Major item	Monetary Policy	Stability and Growth Pact, TSCG	Lisbon Strategy, EU 2020 Strategy, EURO Plus Pact	Ordinary Legisla-tive Procedure	Own resources, multiannual financial framework, annual budget
Mode of governance	Supranational hierarchy	Hard coordination	Soft coordination	Supranational Community Method	Mixed

Source: Wolfgang Wessels, The *European Council*, Oxford and New York, Palgrave Macmillan, 2013 forthcoming.

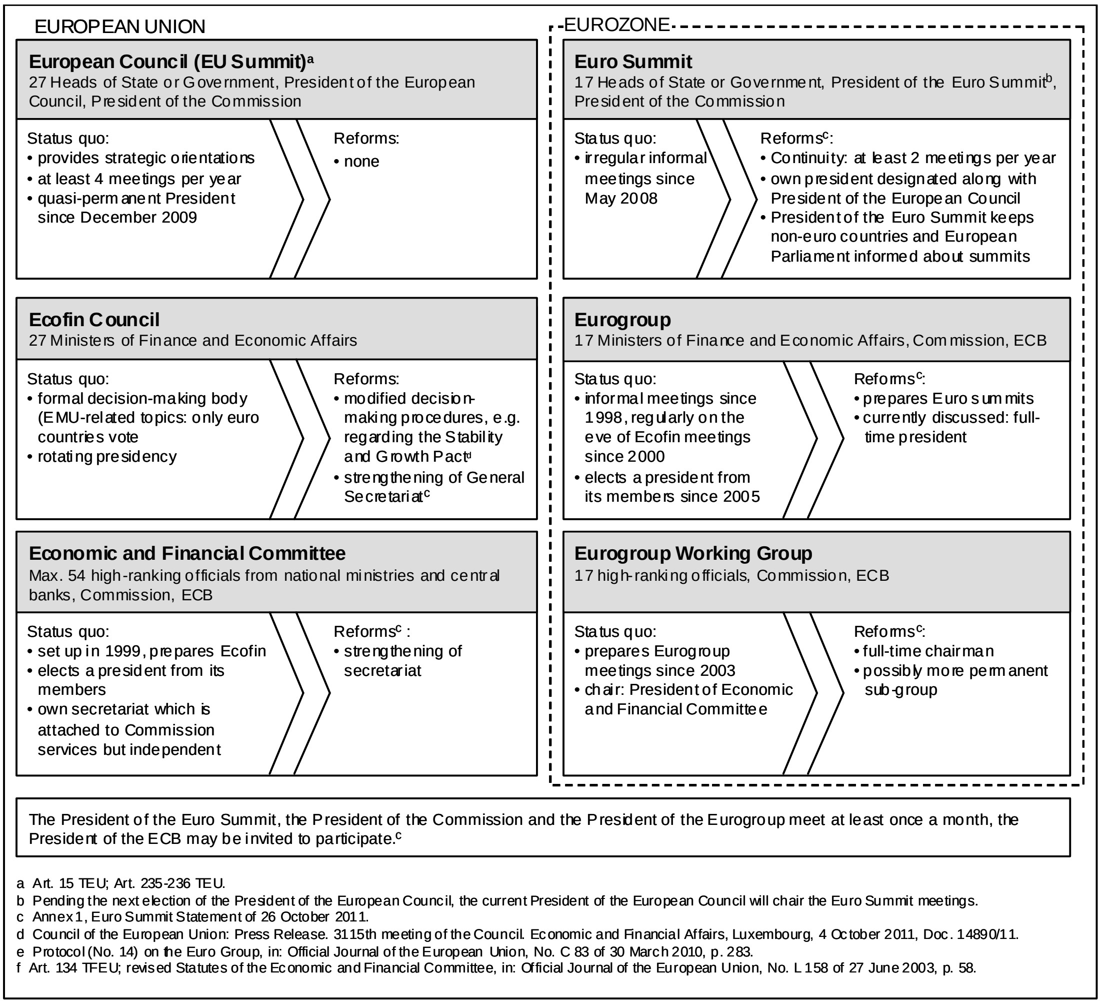
In terms of internal dynamics, the immediate management of the sovereign debt crisis was dominated to a large extent by the French-German duo. Former French President Sarkozy and German Chancellor Merkel were pivotal players - with the German part of the tandem increasingly playing the role of “reluctant hegemon”.[9] Behind the scenes, however, the President of the European Council, Herman Van Rompuy, played an important role, not least through the Task Force for strengthening economic governance set up in 2010. His inconspicuous, yet often successful efforts to reconcile national interests also consolidated the position of the European Council within the institutional architecture.

In terms of institutional differentiation, the Euro Summit emerged as a potential rival to the European Council. Against the background of the October 2011 decision to

[9] William E. Paterson, “The Reluctant Hegemon? Germany Moves Centre Stage in the European Union”, in *The JCMS Annual Review of the European Union in 2010*, Special issue of the *Journal of Common Market Studies*, Vol. 49, Supplement 1 (September 2011), p. 57-75.

complement EU governance structures at all levels with parallel formations for euro area members, Euro Summits have become a decisive element in defining strategic orientations for the conduct of economic policies in the euro area (see Figure 3). In order to ensure some consistency between Euro Summit and European Council meetings, for the time being the President of the European Council also chairs the Euro Summits.

Figure 3. Institutional reforms of economic governance



Source: Tobias Kunstein and Wolfgang Wessels, “What we hope, what we fear, what we expect: possible scenarios for the future of the eurozone”, in *European View*, Vol. 11, No. 1 (June 2012), p. 8.

In revising and extending the existing arrangements for hard and soft economic policy coordination at the European level, the Heads of State or Government took unprecedented steps towards integration, such as the ESM and the TSCG. But European Council and Euro Summit decisions also reflect a trend towards upgrading supranational institutions, especially the European Commission and the ECJ, in order to safeguard past achievements and translate emergency measures into longer-term solutions.[10] It would therefore be misleading to interpret the recent developments as a "revival of the European nation state". All in all, the European Council has not shifted the institutional balance in a clearly intergovernmental direction.

3.2. The parliamentary dimension: accountability at the appropriate level

Besides the European Council, the European Parliament has emerged as one of the primary poles of power in the post-Lisbon institutional system.[11] The way national parliaments interpret and use their new powers has also gained attention since the coming into force of the Lisbon Treaty. But while the Heads of State or Government have been able to use their key role on both the European and the national level throughout the financial and sovereign debt crisis, neither the European Parliament nor national parliaments can be characterized as multi-level players. Nevertheless, the parliamentary dimension is regarded as vital for ameliorating the lack of democratic control of policymaking in response to the turmoil.

In general terms, the European Parliament has acted as a constructive counterpart to the Council in the legislative process in the post-Lisbon period. Although its role in concluding major agreements to overcome the crisis of the euro area has been marginal, it is an indispensable element in holding decision-makers at EU level to account. National parliaments have also - with considerable variations - increased their activities before and after European Council and Euro Summit meetings, even though "only a few of them use their formal opportunities to a larger degree".[12]

Most recently, there is a strong ongoing debate on how to reconcile parliamentary involvement with the increasingly complex multi-tier construction of the EU. Out of concern for the EU's unity, the European Parliament has rejected suggestions to endow a core group such as the euro area with its own parliamentary chamber: "The European Parliament […] is the parliament of the Euro".[13] Increased cooperation among parliaments of both levels to strengthen incrementally their position vis-à-vis the other EU institutions seems to be the most promising option, although probably with limited effects.

3.3. The Commission: a watchdog on a short leash?

The Commission has mostly been described as a loser in the inter-institutional balance over the past years. It has had to cope with a loss of significance due both to the

[10] Wulf Reiners und Wolfgang Wessels, "Rivalität und Gleichgewicht in der institutionellen Architektur der EU", in Werner Weidenfeld und Wolfgang Wessels (Hrsg.), *Jahrbuch der Europäischen Integration 2012*, Baden-Baden, Nomos, 2012, p. 52.

[11] Jorg Monar, "The European Union's institutional balance of power after the Treaty of Lisbon", in *The European Union after the Treaty of Lisbon: visions of leading policy-makers, academics and journalists*, Luxembourg, Publications Office of the European Union, 2011, p. 86, http://bookshop.europa.eu/en/the-european-union-after-the-treaty-of-lisbon-pbNC311068286.

[12] See Wolfgang Wessels *et al*., *Democratic Control in the member states of the European Council and the Euro zone summits*. Study commissioned by the European Parliament, Brussels, European Parliament, 2013 forthcoming, p. 69.

[13] European Parliament, *Towards a real Economic and Monetary Union. Building a capacity to decide*. Reflection Note by the Representatives of the Parliament (PE 497.187/CPG), 2 October 2012, p. 2, http://www.movimentoeuropeo.it/index.php?option=com_docman&task=doc_download&gid=194.

Lisbon Treaty and the rise of the European Council.[14] Nonetheless, as far as economic policies are concerned, the Commission has "received unprecedented supervisory power"[15] in response to the recent crises, for example in the framework of the TSCG for countries subject to an excessive deficit procedure, and for countries receiving ESM assistance. The Commission's evaluation in these cases may ultimately lead to "a deep cut into the parliamentary sovereignty of the concerned states".[16] However, the Commission's traditional role as "guardian of the treaties" in cooperation with the ECJ is weaker in this area: The Commission may not go to the Court directly but has to rely on a member state to take action. Moreover, the fact that the European Central Bank (ECB) rather than the Commission has been assigned the leading role in the SSM currently being negotiated also attests to the strict limitations on its role. Finally, the President of the European Council seems to have superseded the Commission to some extent as a key norm entrepreneur.

3.4. The European Central Bank: the most prominent winner?

The ECB has had to master the double challenge of conducting monetary policy for all euro area member states in an extremely volatile environment, and contributing to the resolution of the sovereign debt crisis. By expanding the banking sector's access to liquidity, as well as through unconventional measures such as the purchase of government bonds, the bank has played a decisive part in preventing the euro area's disintegration. However, some of the ECB's more unorthodox measures have been very contentious. Critics (also from within the Bank) have argued that some dangerous precedents have been set that might eventually put the primary goal of price stability at risk.

Despite this criticism, the ECB as a technocratic supranational body emerged strengthened from the crises and has influenced the debate on reforming EMU. New responsibilities regarding the supervision of banks under the SSM will give it a leading role in day-to-day management of financial markets. But they also pose the new challenge of establishing a strict internal division between these and the ECB's traditional activities, with a view to preventing conflicting objectives between the two domains.

4. Ways ahead: a roadmap towards a more "genuine" and stable EMU?

In the run-up to the December 2012 European Council, several contributions outlined a reform agenda for EMU. *Inter alia*, the European Commission published a

[14] Wulf Reiners und Wolfgang Wessels, "Rivalität und Gleichgewicht in der institutionellen Architektur der EU", *cit.*, p. 47.
[15] Herman Van Rompuy, *The discovery of co-responsibility: Europe in the debt crisis*. Speech at the Humboldt University, Walter Hallstein Institute for European Constitutional Law (EUCO 21/12), Berlin, 6 February 2012, p. 6, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/127849.pdf.
[16] Wulf Reiners und Wolfgang Wessels, "Rivalität und Gleichgewicht in der institutionellen Architektur der EU", *cit.*, p. 14.

comprehensive "blueprint for a deep and genuine EMU" in late November.[17] Most recently, a paper prepared by the President of the European Council "in close collaboration" with the presidents of the Commission, the Eurogroup and the ECB summarized these contributions into a roadmap[18]. While some of the proposed measures can be realized within the present legal framework, others require more fundamental treaty changes.

A major project that is largely compatible with the current legislative framework is the idea of a "banking union" (at least among euro area banks). The intended SSM is a first element of such a regime. Once the SSM is in place, the intention is to let the ESM recapitalize struggling banks directly (instead of lending to governments). Additional steps towards a full-fledged banking union would include a single resolution mechanism for failing banks and a common deposit protection scheme. However, political disputes make it uncertain if the ambitious timetable set out in the Van Rompuy paper can be respected, given that implementing the necessary legislative changes could take several years.[19]

A second major proposal, which would require far-reaching treaty changes, is to establish some centralized "fiscal capacity" for the euro area to protect national economies against financial shocks. The insurance-type system - open to the 10 euro-outs on a voluntary basis - would include national contributions according to economic performance, but is not supposed to provide permanent transfers between countries. The Van Rompuy paper takes care to underline that the fiscal capacity would not imply the mutualization of debt, but notes that it could indeed offer an appropriate basis for common debt issuance. Regardless of this aspect, a centralized fiscal capacity for the euro area would constitute a decisive step towards an autonomous euro area budget.

Conclusion and outlook: towards "more Europe"

In terms of the inter-institutional balance, the crisis seems to have strengthened the European Council as the incarnation of intergovernmentalism within the Union. But there are also arguments that the European Council has reinforced the Community method[20] and might have become communitized itself.[21] Spillover effects would thus lead to more European federalism, reflected in the strengthening of supranational institutions (the European Parliament, along with the ECB and the ECJ). In sum, given that national parliaments are also increasingly making use of their rights, we may see a development towards power-sharing in the evolution of the EU's architecture.

[17] European Commission, *A blueprint for a deep and genuine economic and monetary union. Launching a European Debate* (COM(2012) 777 final), Brussels, 28 November 2012, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM%3A2012%3A0777%3AFIN%3AEN%3APDF.
[18] Herman Van Rompuy, *Towards a Genuine Economic and Monetary Union*, 5 December 2012, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/134069.pdf.
[19] Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, *Nach dem EU-Gipfel: Zeit für langfristige Lösungen nutzen, Sondergutachten*, 5 Juli 2012, p. 28, http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/download/publikationen/sg2012.pdf.
[20] See Herman Van Rompuy, *The discovery of co-responsibility: Europe in the debt crisis*, *cit*., p. 6.
[21] Wolfgang Wessels, *The European Council*, *cit*.

An assessment of the forward-looking roadmap is more difficult. The European Council of December 2012 embraced the blueprint of a “genuine EMU”, but deferred many open questions on the further transformation of the euro area to the next year. Against the background of the relative calm in financial markets over the past few months, it will be important that this lack of a sense of urgency does not translate into a return to business as usual. In order to make the common currency more resilient, long-term reforms are clearly necessary. All elements of the new governance architecture need to be considered in a broader perspective of constructing the EU polity. In their final report of September 2012, a group of foreign ministers underlined that the overall functioning of the EU needs to be strengthened independently of EMU reform.[22] Both undertakings might require a revised Treaty created by a constitutional convention - of either all EU members or just those willing to press ahead. Regardless of which option prevails in the end, it is becoming increasingly difficult to preserve simultaneously the (geographic) breadth and (institutional) depth of the process of European integration. “More Europe” in terms of making EMU more resilient to crises will in all likelihood be accompanied by “less Europe” in terms of differentiated integration in the EU polity as a whole.

Updated: 11 January 2013

[22] Future of Europe Group, *Final Report of the Future of Europe Group of the Foreign Ministers of Austria, Belgium, Denmark, France, Italy, Germany, Luxembourg, the Netherlands, Poland, Portugal and Spain*, 17 September 2012, http://www.auswaertiges-amt.de/cae/servlet/contentblob/626338/publicationFile/171838/120918-Abschlussbericht-Zukunftsgruppe.pdf.

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Istituto Affari Internazionali
Via Angelo Brunetti, 9 00186 Roma
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