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Elena Makrevska Disoska[1]

INFLUENCE OF THE EURO CRISIS ON THE PROSPECTS OF THE EUROPEAN SINGLE MARKET

There is a growing concern about the future of the European Monetary Union (EMU) and the sustainability of the Euro. The worst case scenario: the break-up of the Single currency would not remain limited to the EMU itself, but would cause huge macroeconomic disruptions. Furthermore, if the countries reintroduce their national currencies, economically stronger countries will experience domestic currency appreciation towards the weaker economic counties. That would mean reduction of their exports, i.e. reduction of the price competitiveness. In such a situation, in order to protect their domestic economies, the countries will introduce protectionist measures which would suspend the Single market. Without the free movement of factors of production it is impossible for the Union to survive. This means that if the Eurozone falls apart, there will be a complete end to the Union. Returning back to the stages of regional integration as common market or customs union is theoretically impossible. Still, in any possible scenarios for how the Euro crisis might develop would adversely affect the Single market. Solving the macroeconomic imbalance of the Union will be a condition for its sustainability in the future and for insuring better future prospects of the Single Market.

JEL: F15; F62

Introduction

The establishment of the Single Market is one of the biggest successes of the European Union (EU), which enabled the EU to grow into a higher level of regional integration - Monetary Union. The creation of the EMU meant successful launch of the Euro in January 1999 and loss of the independence of the national central banks. After the establishment of the Single Market, the EU moved directly to the creation of a Monetary Union, without having secured full functioning of the economic union, which was a major flaw in the regional integration process.

Although convergence in interest rates was achieved and there was an increased fiscal integration, the Eurozone did not achieve proper allocation of capital, which is confirmed by the creation of price bubbles and high budget deficits of the member states. The reason underneath is that there was low harmonization of fiscal policies of the member states of

[1] *Elena Makrevska Disoska, PhD is from Faculty of Economics - Skopje, University Ss. Cyril and Methodius in Skopje, Republic of Macedonia, e-mail: elenam@eccf.ukim.edu.mk.*

the Union, which has become a major problem with the emergence of the global financial crisis. The crisis has not only affected the Union's internal balance through increased fiscal spending, but in turn, these developments were reflected with disruption of the Union's external balance. During the last decade of the twentieth century, the EU is gradually losing positions in the world markets and continues to widen the negative trade balance.

The effect of the crisis revealed significant shortcomings in the structure of exports, the different economic structure of the countries within the Union, the various and unsynchronized measures that countries applied in order to face the consequences of the crisis, etc. It certainly created a negative trade balance, which was not only a result of the impact of the global financial crisis. High trade deficits coupled with significant losses in competitiveness, a high level of public and private debt; unsustainable increase in property prices suggests deeper structural problems, and indicates a lack of cohesion between the member states of the Union. The Union must face these challenges in order to sustain the leading positions in the world.

1. EU positioning on the world market

The creation of the Single Market enabled free movement of goods, persons, services and capital - "four freedoms”. According to estimates of the European Commission, between 1992 and 2013 the Single Market together with the enlargement process created 3 million jobs and contributed 1.12% of the GDP growth in the EU. Trade within the EU today constitutes 17% of the world trade and 28% of services, which shows its significance in terms of world economy and trade. Other gains have been also realized through the establishment of the Single Market such as: increased levels of market competition, increased levels of innovation, lower costs and prices and a greater choice for consumers.

The global economic crisis that began in 2008 had a profound impact on the EU and the Eurozone member states' economies. After significant fall in the GDP growth rates during 2008/2009, the economy of the EU/Euro area is slowly recovering, but the growth is still modest (figure 1a). Another indicator for the economic growth is GDP per capita. According to the calculations of OECD (2014), the Eurozone has significant declining values of the GDP per capita index (figure 1b), due to the cut in the growth forecasts for the expected performance in the Eurozone’s biggest economies, Germany, France and Italy. The Organization for Economic Cooperation and Development delivered its own pessimistic appraisal “The Eurozone is the locus of the weakness in the global economy.”

The declining foreign demand in the wake of the 2008/09 global economic downturn also hit the EU export sector particularly hard – 23.10% in 2008 compared to 2007. Trade balance of the Union in the whole period of EU existence had a mainly negative value i.e. the value of imports has been higher than the value of export and has been worsening over the last decade. Since 2002 the trade deficit is widening, and it reached the highest negative value in 2008 (525.1 billion Euros). The recovery was in 2009, when the trade balance showed positive tendencies. Only in the period 1993-1998, the EU exerted a positive trade balance (figure 2).

Figure 1a

Real GDP growth rate- volume (percentage change on previous year)

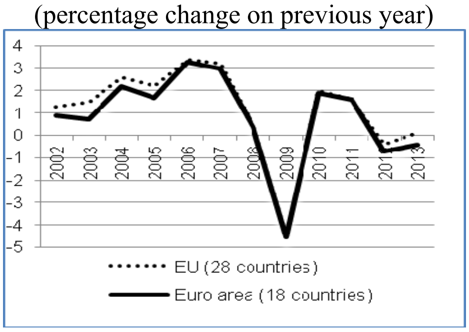
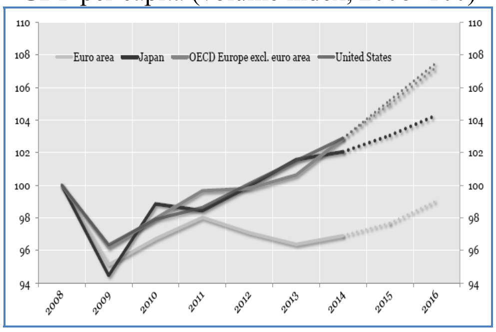


Figure 1b

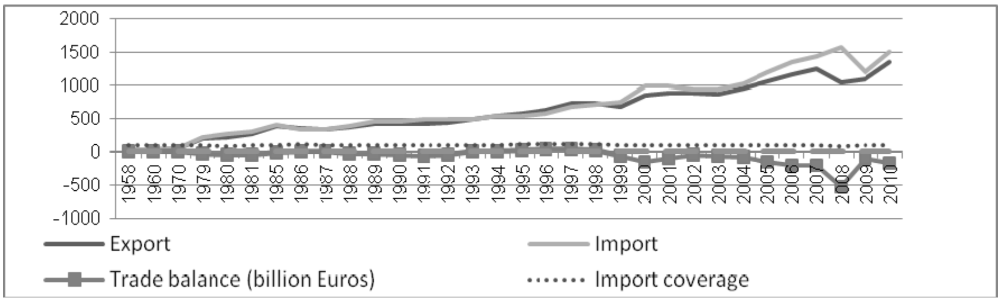
GDP per capita (volume index, 2008=100)



Source: EurostatdatabaseSource: OECD 2014, *Economic Outlook database 2014*, November 2014. Available from: <http://www.slideshare.net/oecdeconomy/advance-g20-release-of-oecd-economic-outlook>. [8 December 2014].

Figure 2

External trade of EU with the rest of the world



Source: Eurostat 2011, *External and intra-EU trade: A statistical yearbook, data 1958 – 2010*, Luxemburg, European Commision, pp. 14-16. Available from <http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-GI-11-001/EN/KS-GI-11-001-EN.PDF>.[16 August 2014].

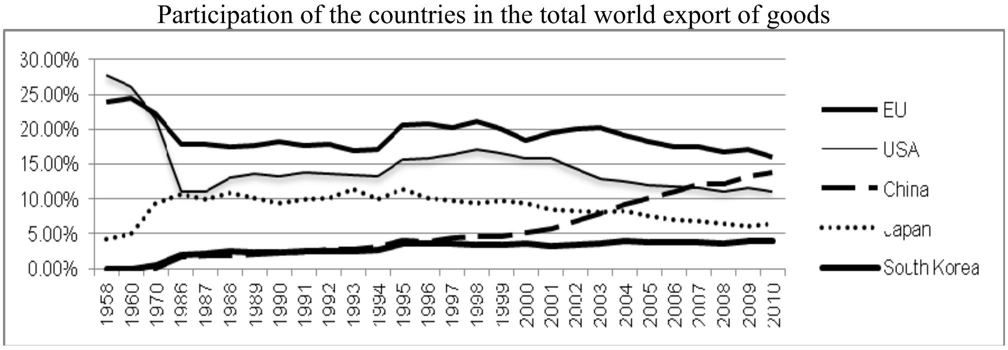
The problem is systematic.The trade deficit of the EU is a result of the countries that traditionally achieve trade surplus (Luxembourg, Finland, the Netherlands and Germany) and countries with traditionally high deficits (Greece, Portugal and Spain). However, the deficit in the trade account of Greece, Portugal and Spain was balanced until the mid 1990s. Obviously, the process of convergence of these countries in the Monetary Union impacted negatively on the country, resulting in deepening deficit due to the process of adaptation to the Euro. Just for example, the Spain balance of trade increased in 2006 approximately fourfold compared to1999 (Trading Economics 2014).

According to the share of the export of the EU in the world export, the relative indicator is also slowing down (figure 3). With the exception of the period 1958-1960, the Union had the highest share in the value of world exports in the whole observed period. In 1996, EU had a 20.8% market share of the world trade in goods (excluding intra-EU). This market share has been lowered by competitive pressures from emerging economies, falling to 16%

in 2010. The second largest world exporter was the USA, whose share has been declining gradually since 2000. The most remarkable development is that China as fastest growing economy from 2005 onwards become the third largest exporter in the world, followed by Japan as the fourth largest world exporter. Thus, if we make comparison, we can see that the rise in the export share of China for 10 p.p. from 1996 to 2010, has been fairly affected by the EU (fall of 4,8 p.p.), USA (4,6 p.p.) and Japan (3,7 p.p.) over the same period.

Figure 3

Participation of the countries in the total world export of goods



Source: Eurostat 2011, *External and intra-EU trade: A statistical yearbook, data 1958 – 2010*, Luxemburg, European Commision, pp. 14-16. Available from <http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-GI-11-001/EN/KS-GI-11-001-EN.PDF>.[16 August 2014].

These trade fluctuations led to increasing concerns about the prospects for EU exports and competitiveness, particularly at a time when exporters had already been struggling to adjust to the fiercer competition and other structural changes resulting from globalization. We may conclude that the fluctuations are mainly result of the differences in productivity and competitiveness of the countries, as well as of the different effects of the macroeconomic policies on economies of the member countries, which lead to the further increase of imbalances between them. Therefore, the beginning of the global financial crisis did not caused the problems of the EU. They only revealed the hidden weaknesses in the creation and functioning of the Union.

2. Functioning of the Single Market

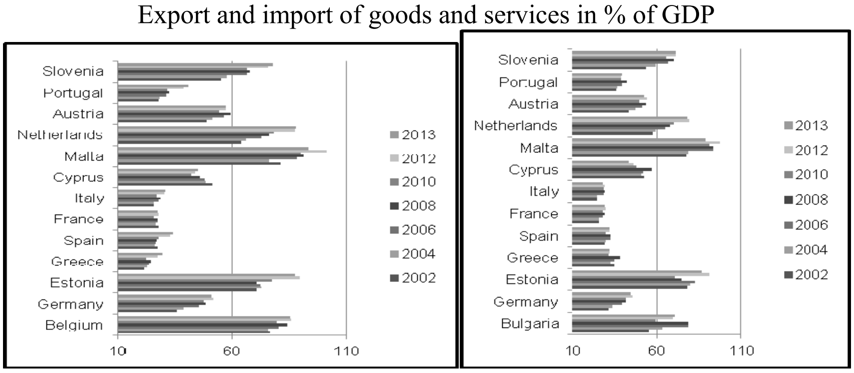
Even though the Single market brought many advantages for the EU countries it is still fragmented by the domestic producers that do not use the advantages of the economies of scale as a result of not synchronized policies. In order to present the functioning of the Single market in the following chapter we will elaborate the free movement of goods, services, people and capital.

2.1. Free movement of goods and services

Trade openness is widely believed that contributes for higher economic growth (Frankel and Romer 1999). Also when countries with high level of trade relationship accept common currency they benefit more due to the elimination of transaction costs (McKinnon, 1963).

Figure 4

Export and import of goods and services in % of GDP

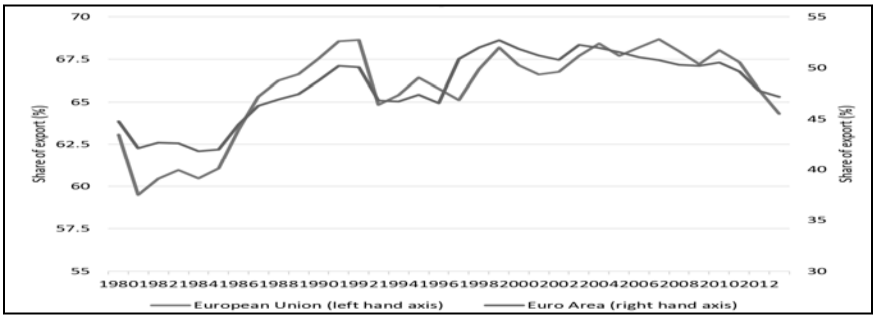


Source: Eurostat database.

The level of trade openness of EU countries, as total value of import relative to the country`s GDP is presented in figure 4. The data show that the degree of trade openness between countries significantly varies, from very open economies, such as Belgium, Estonia, Malta to rather closed economies, such as Italy, France, Spain and Germany. Therefore, small countries benefit more from joining the Eurozone rather than the bigger ones.

Figure 5

Intra trade of EU/Eurozone countries



Note: The above figure shows intra-EU and intra-Eurozone shares of export on total export of the two groups respectively. Each of the two lines were constructed taking into account the changing composition of the European Union and the Eurozone over time, meaning that a given country is included in the series only by the time it joined the EU or the Euro. However, further calculations shows results do not change dramatically if considering a fixed group of countries in either series.

Source: Mazzolini,G 2014, Sharp decline in intra-EU trade over the past 4 years. 27th August 2014. Bruegel: Blog. Available from:<http://www.bruegel.org/nc/blog/detail/article/1420-chart-sharp-decline-in-intra-eu-trade-over-the-past-4-years#republishing>**.** [2December 2014].

Regarding the intra trade in EU/Eurozone, it is decreasing over the years (figure 5). The share of the intra-EU export of the EU total export experienced a steady rise of 8 p.p. since the early 80'. However, after stagnating from the mid-90's until the end of the 2000's, intra-EU saw a sharp downward trajectory in the last years. Interestingly, the data also show that the Eurozone has been following nearly the exact same pattern as the European Union as a whole, suggesting the common currency might not have had the expected effect on trade between Eurozone members (Mazzolini, 2014).

2.2. Labor force mobility

Although free movement of people is one of the key principles of the Single market, mobility is still a limited phenomenon in Europe compared to other regions of the world: annually, only 0.3% of the EU population moves to another European country, compared, for example, with 2.4% in the USA or 1.5% in Australia. Overall, only 3.1% of the working-age European population (15-64) was living in an EU member state other than their own in 2012 (Dhéret et al., 2013).

The main reasons for low mobility are: *Human barriers*: inadequate institutions on the labor market, problems with transfer of pensions and social benefits and acknowledgment of qualifications and experience, as well as insufficient qualification of the labor force in EU. Thus in 2013, the average unemployment rate in EU of the people with primary school or lower high-school education is 19.1%, and is three times higher than the unemployment rate (6.4%) of the people with tertiary education (Eurostat database) and *Ordinary barriers* that include different types of social, cultural and language barriers, as well as the age of the working population.

Figure 6a

Wage index, nominal value – annual data (2000=100)

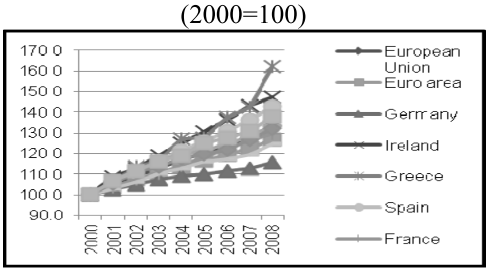
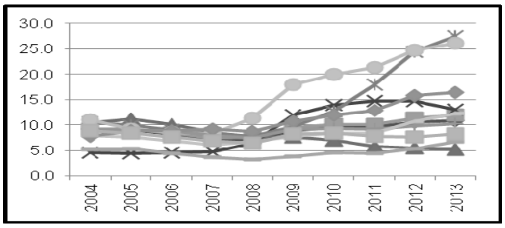


Figure 6b

Unemployment rate, annual average %



Source: Eurostat database.

In respect to the labor market, the data (figure 6a) suggests that the wage flexibility is quite low. The wage index within the EU/Eurozone shows that after 2002 the wages in almost all of the European economies started growing intensively. Despite the intensive wage growth which is a long term trend, during the whole period since 2002, the peripheral member states register high unemployment rate, which indicates low wage sensitivity to the unemployment movements. Thus, higher wage growth caused productivity slow down. Additionally the cyclical effect of the crisis caused additional losses in the labor productivity, meaning faster decline of output relative to employment during the slump. Between the first quarters of 2008 and 2009, production decreased by 19% while hours worked fell by 8% (European Commission 2013).

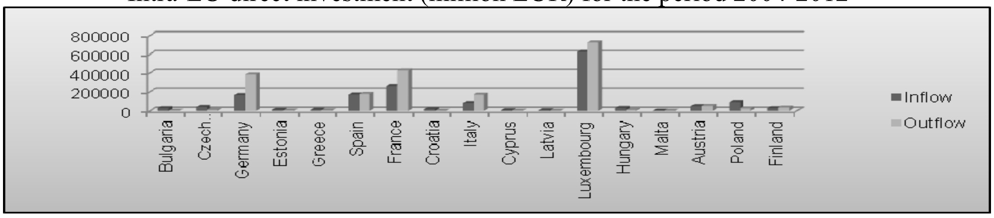
2.3. Capital mobility

Capital moves between countries in the form of portfolio and foreign direct investment - FDI (Jovanovic, 2002). We will analyse only the FDI mobility since it comprise the largest part of the capital mobility. Within the EU, FDI flows are a crucial element for the consolidation of the Single Market, while investments to and from the rest of the world ensure that the EU is well positioned in world markets and able to profit from worldwide technology flows.

The analysis of the FDI by countries points to significant geographical concentration meaning that largest part of the FDI was directed from and towards the six most developed countries (figure 7). The data shows that since 2009 the inflow in the peripheral countries is almost insignificant, due to bad infrastructure, large state administration, undeveloped product services and qualifications of the employees, which all contribute to lower return on investments.

Figure 7

Intra-EU direct investment (million EUR) for the period 2004-2012



Source: Eurostat database.

Intra FDI between EU countries are determined by variables such as: gross domestic products of home and host economy and distance between them, as well as. The influence of Eurozone on intra FDI appears to be neutral or slightly in favour for states which adopted common currency. Therefore, the investment position of Eurozone seems to rather stable besides the acceptance of the single currency (Folfas, 2012).

3. Facing the Eurozone crisis

Except the low mobility of labor force and capital, EU countries have lack of wage flexibility and also different economic structure meaning that EU does not have convergence in the business cycles. According to the theory of optimal currency areas (Mundell 1961, McKinnon 1963, Kenen 1969), the EU is not an optimal currency area (Palankai, 2007). The theory claims that the optimum currency area is defined as an economic entity composed of states that are symmetrically affected by certain economic shocks and in which there is full mobility of labour and capital, while the exchange rate as an instrument for maintaining the equilibrium in the balance of payments and the monetary policy autonomy are lost. The major assumption of the concept of optimal currency areas is that in terms of removal of foreign exchange risks, the manufacturers perceive the entire area as a single market.

In this regard, it can be concluded that in the event of economic shock, when there is no flexible foreign exchange regime and autonomous monetary policy in the member states, the labor mobility or wage flexibility cannot recover the differences among the economies in the Monetary Union and cannot offset the negative effects of asymmetric shock (Trpeski, Kondratenko&Jankoski 2013).

With the escalation of the economic crisis, the capacities of the national fiscal policies for implementing contra-cyclical measures dramatically increased, which led to the domestic fiscal policies being "captured" in high debts and deficits. Following the fiscal achievements of the Eurozone member states, there is a significant deviation from the given rule with the Maastricht Treaty and the Stability and Growth Pact, that stipulates maintenance of the budget deficit not higher than 3% of GDP, and the public debt may not exceed 60% of GDP. Suffering from an unsustainable combination of overly high government structural deficits and accelerating government debt levels the interest rate spreads for government bonds increased extending that some of the Eurozone states needed to be rescued by sovereign bailout programmes. The internal problems of the Union were revealed, causing the European debt crisis or Eurozone crisis.

In order to solve the European debt crisis, the Union gave financial support to the member states that have financial and structural problems in their economies. Therefore in May 2010 the European Union and the Eurozone Member States set up a stabilisation mechanism that consists of: the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF) on temporary basis until 30.06.2013. In addition, in October 2012 the European Stability Mechanism (ESM) was introduced on permanent basis. Alongside with the EFSM, EFSF and ESM, funding is also available from the International Monetary Fund (IMF) and ECB (European Central Bank) for purchases of sovereign debt on secondary markets (European Commission, 2014).

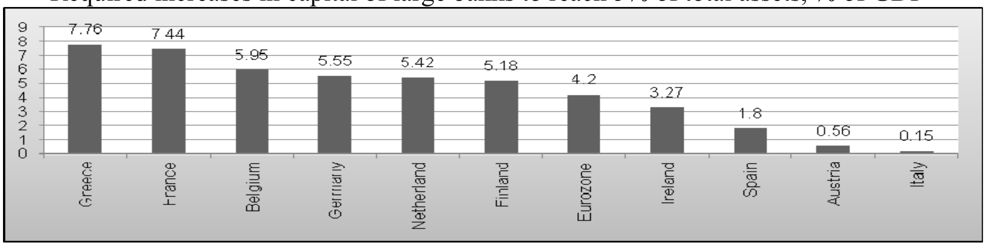
The anti-crisis monetary policy that has been currently applied by the ECB implies expansionary monetary policy by reducing interest rates and the use of quantitative release, i.e. redemption of financial assets from banks that typically have high credit risk in order to increase the liquidity of the banking sector. Most important of all is that the banks are funded by the European Central Bank, while household deposits slowly but steadily drain from their balance sheets. This process is mostly characteristical of the countries that face the greatest problems in the banking sector such as: Greece, Spain, Portugal and Italy.

Low bank capitalization persists in many countries despite the EU requirement that banks in 2012 reach a ratio of a minimum of 9% of the best quality "Core Tier-1" capital to risk-weighted assets, in excess of the current international requirements. Increasing the capacity of European banks to absorb losses by increasing their capital relative to assets, needs to be addressed in the upcoming years. If the Eurozone's largest banks were to move to a 5%

standard, the current capital shortage is estimated at around EUR 400 billion (4¼ per cent of Eurozone GDP). This is not just a problem for banks in the "periphery" – there could be large capital needs in the major Eurozone countries such as France, Germany, Netherland and Finland (figure 8). Future capital needs could be lessened if banks were required to separate commercial banking and market activities, reducing the total assets of the banking business. Moving towards a stronger banking system - creating a banking union would help to rebuild confidence and get credit flowing again (OECD 2014).

Figure 8

Required increases in capital of large banks to reach 5% of total assets, % of GDP



Source: Organization for Economic Co-operation and Development 2012, OECD Economic Outlook, Washington, OECD publications, vol. 2012/2. Available at: <http://www.oecd-ilibrary.org/economics/oecd-economic-outlook-volume-2012-issue-2_eco_outlook-v2012-2-en>. [15 November 2014].

On the contrary, loss of confidence in the domestic banking sector and more generally in the Eurozone can cause major negative consequences for the Union. Large outflow of capital can cause a weakening in the banking system in these countries. This in the long run can mean exit of the countries from the Eurozone, freezing deposits in domestic banks and their conversion into domestic currency. Domestic currency of these countries in this case would experience high devaluation against the Euro.

Unfortunately, the European Central Bank cannot prevent this occurrence. As long as the bond yields and interest of the deposits are high, and the economic growth is weak, national governments and banks will face reduced capacity to service their obligations. Moreover, the fear of national governments to face a banking crisis makes their bonds riskier and compulsorily increases their yields.

4. Plausible outcomes of the Eurozone crisis and impact on the Single market

In the context of the reforms and challenges, there are several views on what will be the future of the Union. *The first view* refers to the further financial support from the Union to the member states that have financial and structural problems in their economies. Negativity in this strategy is that such funding will cover costs that were used for unproductive purposes. Instead, future funding should be directed towards productive purposes to ensure higher rates of economic growth in the future, which will be able to compensate the current losses. Negative experiences of the member states from the asymmetric shocks caused by the global economic crisis should accelerate the decisions of the national governments in the implementation of budget reform and reforms in the labor and capital market. It would also contribute to improving the economic situation of countries and their competitiveness. This can also increase the confidence in the Union and support the process of further enlargement of the Union.

The *second view* suggests that EMU eliminates the Member States which have large deviations from the Maastricht Criteria. There is evidence that as early as 1998 four professors from Germany: Joachim Starbati (University Tuebingen), William Henkel (University of Cologne), Karl Albrecht and William Nolingfiled a lawsuit against the introduction of the Euro by Greece. They generally opposed to the introduction of the Euro due to the unpreparedness of the countries. They considered the entrance of Greece into the Eurozone unacceptable, primarily because of the weak economic power of the country (Starbatty 2010, 'Der Euro-Fighter', para.5). They proved to be right, as the problems of the Eurozone escalated during the economic crisis. The situation might have been different if Greece had not been accepted as a member state back in the time, however, an exit from any country from the Eurozone at this point can cause bigger problems to the Union.

Withdrawal from one or more members could cause full breakup of the Eurozone. An exit of one country would lower the confidence that would cause further withdrawals. In the course of these events, it is very likely that the Eurozone would end up either completely fragmented or much reduced in size – that is, without Greece, Italy, Spain, Portugal and Ireland. However, that does not solve the problems of the Union. Also, within the Eurozone there is no law under which the country may voluntarily depart (Athanassious 2009).Thus, if a country wants to give up membership from the Eurozone and wants to replace the Euro with its domestic currency, it must renounce the membership in the Union as a whole. That would mean give up on the benefits provided by the functioning of the Customs Union (Lisbon Treaty 2007 (Cth) art. 49a).

Generally the problems of the Union can be shared between countries. The southern countries in the Eurozone are trapped in recession and cannot restore their competiveness by devaluating their currencies and on the other hand, the northern countries in the Eurozone are being asked to compromise their values of prudent financial policies and act as ‘deep pockets’ expected to finance the South through endless bailouts. This situation risks the outbreak of serious social unrest in southern Europe and deeply undermines public support for European integration in northern European countries. The Euro, instead of strengthening Europe, produces divisions and tensions that undermine the very foundations of the European Union and the Common market. Considering this situation the *third solution* will be if the Eurozone split into two regions.

An economically stable core of Europe will be one region and the “profligate”countries in the Mediterranean will be members of the other region. The stable core would consist of countries like: Germany, France, Netherlands, Belgium and Luxemburg. The other region of Mediterranean countries would consist of Greece, Portugal, Spain and Italy. According to this solution therewill be a North-South division, which will stimulate the Mediterranean countriesto reduce their budget deficit and to join the South region (Alderman2010, 'The New York Times', para.8). But, where will Ireland belong? According to the economic performancesit belongs in the South, but according to the geographic location it is in the

North. That will cause problems to the intra trade. The separation of the two regions cannot be that easy even in the terminological sense. Also in order to be achieved institutional adoption it will take too much time (just for comparison three years were needed for the introduction of the Euro).

Conclusion – Prospects of the EU/Eurozone

The problems of the Euro crisis cannot be separated with the Single market. In this regard, it can be concluded that in the event of economic shock, when there is no flexible foreign exchange regime and autonomous monetary policy in the member states, the lack of labour mobility or wage flexibility cannot recover the differences among the economies in the Eurozone.

We may conclude that further trade opening can play an important role in moving the countries out of the crisis. Single Market reforms and external competitiveness are inextricably linked. Long-term expectations and needs for the Single Market is to make a comprehensive structural changes in order to overcome structural differences between individual Member States, to increase the overall competitiveness of the Union and individual by country, to remove trade barriers between individual Member States and to achieve higher individual and aggregate rates of economic growth. It is clear that the effects of deep integration of the EU has not yet been achieved, and expected benefits may not be realized, if the internal and external balance of the Union is not achieved.

The main challenge for the EU is whether to accede to full withdrawal from the Euro, which will cause economic and political consequences for the Union, or to boost funding and increase solidarity among Member States. Solidarity between Member States would mean willingness European lenders, primarily Germany, to continue with further funding and willingness of debtor countries to accept support and comply with the set rules.

It is likely that the EU will accede to the first view, i.e. will continue with further financial support to countries with financial and structural problems in order to preserve its geographical boundaries. Hence, the continued survival of the Euro is determined by the political decisions of the member states to pursue further financial support and to improve the level of solidarity between countries. However, this policy is sustainable only in the short term. The planned slowdown in the pace of fiscal consolidation, stronger financial conditions and further monetary stimulus should support the recovery. In this regard creation of fully operational Banking union should provide a stronger foundation for cross-boarding capital flows in general. Macroeconomic measures that stimulate the demand must be present in order to support the growth performance of the Union. If funding fails to produce the desired effects in order to strengthen the economic strength and competitiveness of economies, the Union will have to face scenarios that are not in favor of its future, like the second and third view.

Thus even in this bestcase scenario the Single market would suffer. Although the costs of rescuing the Euro are too high, the cost of its withdrawal is far bigger and unnecessary. If it happens that some countries abandon the Euro (*second view*), that would probably lead to complete collapse of the Union. The problem is that the domestic currency will undoubtedly devalue to the economically weaker countries as already mentioned, and it will increase its liabilities, domestic or foreign to be denominated in foreign currency. It not only means lower liquidity of the private sector, but also an increase of the public sector debt. Increased volume of private and public debt will force the country to cut spending or print an additional amount of money that can cause inflation. The same scenario would happen if the counties accept the *third view*. Additionally it will create problems in the intra trade which will worsen the situation.

With the collapse of the Monetary Union, global stock prices will fall, many of the banks would fail due to poor balance of payment and the production in countries under the pressure of events would be reduced. With the collapse of the Monetary Union, countries would re-introduce their domestic currency. That would mean that the economically stronger countries will experience the appreciation of their domestic currency towards economically weaker countries. Stronger currency of the economically stronger countries would influence the reduction of their exports, i.e. by reducing price competitiveness. In such a situation, these countries in order to protect domestic economies will introduce protectionist measures that would suspend the Single Market. Without free movement of factors of production it is impossible for the Union to survive. This means that if the Eurozone ceases to exist, it would mean a complete end to the Union. Returning back to the stages of regional integration as a Common market or Customs union is theoretically impossible because of the great effects that will be caused by the collapse of the Eurozone.

But if we look forward, it is logical to expect that the EU should grow into a Federacy. The most important thing in the process of federalization is homogenization of the regulation and control of the financial institutions in the EU, regulations for the balance of payment and harmonization of the taxation system. What would be the use of this federalization? It would help with EU regulations, to have better enforcement of the structural reforms and hopefully better results. For example, structural reform for increasing the flexibility of the labor market (in the region with same regulation) will increase the competitiveness of the region.

Europeans will never view the Union as the citizens of California and Texas see the American union. Without this, political union in Europe is impossible (Stuvard, 2009).Still, the creation of a political union is not a necessary step for saving the stability of the Union. Only, economic and political cooperation is needed among countries that can stimulate and affect coordination between countries in terms of the application of economic policies and structural reforms. The measures that the Union is taking are leading towards establishment of higher economic and fiscal cooperation between the countries. Only by strengthening the lose basic of the Union, the EU might get out of the crisis.

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