

All roads lead to Frankfurt – the results of an enigmatic summit

Summary

The 8-9 December European Council was not the 'major breakthrough' many had hoped for in the run-up to this crunch meeting of EU leaders: it is not likely to go down in history as the meeting which turned the tide, and the EU is destined to remain in 'crisis mode' for some time to come. This EPC analysis by Janis A. Emmanouilidis concludes that the summit sent very mixed signals to policymakers, experts, citizens and investors, but one thing is clear: the most important question asked ahead of the summit – will the EU be able to contain the euro crisis? – will not be answered in Brussels or in any other EU capital, but in Frankfurt, by the European Central Bank.

Full report

As so often over the past two years, the European Council on 8-9 December 2011 was dominated by issues related to the sovereign debt crisis – a crisis which had worsened after the summit marathon in late October failed to rebuild trust in the euro with commentators, citizens and investors remaining unconvinced that the European Union could contain, manage and ultimately overcome it.

Facing crunch time

In the run-up to the summit, the crisis appeared to be moving steadily closer to crunch time. As the situation continued to deteriorate, it became clear to almost everyone that it was not 'only' the stability of the common currency that was at stake, but also the future of the whole European project. Without decisive action, the unthinkable might become possible: the break-up of the euro zone and even the disintegration of the EU – at least as we know it.

An implosion of the euro would affect all EU countries – inside or outside the euro area and irrespective of their size – albeit to different degrees, with potentially horrendous financial, economic social and political consequences: the collapse of the financial system; a long and deep depression; mass unemployment and impoverishment; the collapse of the EU's peripheral economies; social riots and violent conflicts, deep divisions between national capitals blaming each other for the failure to contain the crisis; nationalism and populism reaching levels not seen for generations – all of this could be on the cards if the EU and its members cannot stop the crisis from snowballing.

In the weeks before the summit, the crisis had penetrated even deeper into the centre of the euro zone, as Italy, Spain and Belgium's debt costs climbed to levels close to those that forced Greece, Ireland and Portugal to seek shelter under the rescue umbrella. The European Central Bank (ECB) was buying more bonds on the secondary market and providing more liquidity to banks. The risk premiums for countries like Austria, Finland, France, or the Netherlands, which up till now had appeared immune from the crisis, had increased. Slovakia, Slovenia and Hungary had problems in selling their bonds, as private investors increasingly lost confidence that the euro zone would be able to overcome the crisis, and Budapest had to knock on the International Monetary Fund's (IMF) door once again to ask for support.

In the days ahead of the summit, Standard & Poor's issued a warning that the European Financial Stability Facility (EFSF) and all the eurozone countries risked being downgraded, including the six triple-A countries (Austria, Germany, Finland, France, Luxembourg, and the Netherlands). There were increasing doubts about the size and adequacy of the existing liquidity net and particularly about the real effects of EFSF leveraging.

The breaking of the exit taboo increased fears that some countries might have to leave the euro area. The international press reported that major companies, financial institutions and even banking authorities were preparing for a break-up. Greece was still negotiating with its lenders on the detailed conditions for a bigger Greek haircut, which had been agreed at the last Euro Summit on 26-27 October. The new Italian Prime Minister Mario Monti warned his compatriots that Italy risked a Greek-style 'collapse' if it did not adopt the tough emergency package of tax increases, structural reform and spending cuts proposed by his government.

In the week of the summit, the Organisation for Economic Cooperation and Development (OECD) issued a strong appeal to the EU, and especially the Euro 17, to intensify their efforts to overcome the crisis, which in the words of the OECD "remains the key risk to the world economy". US Treasury Secretary Timothy Geithner's tour of major European capitals testified to Washington's mounting concern. The gravity of the crisis was also underlined by the concerted action taken by the ECB and the central banks of Canada, Japan, Switzerland, the UK, and the US to provide liquidity to the financial system.

On Day One of the summit, the European Banking Authority (EBA) announced that the recapitalisation needs of major European banks were higher than expected (close to €115 billion instead of €106 billion). On the same day, the ECB announced an interest rate cut to counter an economic downturn and President Mario Draghi asked EU governments to be more decisive and act quickly, while at the same time indicating that the Central Bank was not ready to intervene more aggressively, which not only sent shockwaves around global stock markets but also further increased pressure on EU leaders to deliver tangible results.

Diverging positions

This was the backdrop as the 27 EU heads of state and government arrived in Brussels on 8 December. The tensions between EU governments and between some governments and the EU institutions had increased in the run-up to the summit, with differences of opinion on key issues from introducing collateralised debt arrangements (Eurobonds, Stability Bonds) and giving the EFSF or the European Stability Mechanism (ESM) a banking licence to changing the ESM voting procedure, increasing the EFSF's liquidity net, giving the European Court of Justice (ECJ) a role in the surveillance of fiscal discipline, and amending the EU Treaties.

There were dividing lines everywhere in the EU 27. Non-euro countries felt increasingly sidelined by the Euro 17. Smaller euro members were angered by the way decisions were being pre-cooked in Berlin and Paris and by their exclusion from smaller circles such as the 'Frankfurt Group' (an informal grouping of German Chancellor Angela Merkel, French President Nicolas Sarkozy, European Council President Herman Van Rompuy, European Commission President José Manuel Barroso and Eurogroup President Jean-Claude Juncker). There was mounting frustration at Berlin's perceived attempts to impose its views and positions on the rest while at the same time blocking other key innovations/decisions supported by a majority of member states (collateralised debt; banking licence for EFSF/ESM; stronger ECB involvement).

Finally, there were increasing signs of a potential showdown with UK Prime Minister David Cameron, who came to Brussels under pressure from his own party and threatening to veto a treaty change if a string of conditions ("safeguards") were not met – notably, his demand for a protocol to be added to the Treaties allowing for a switch from qualified majority voting in the Council to unanimity on various issues in the area of financial affairs.

The European Council started with a dinner on 8 December, and the first 'day' ended with a joint press conference by Presidents Van Rompuy and Barroso in the early hours of Friday. The second day was also dominated by the euro crisis, with other items on the agenda – energy, EU enlargement, Schengen enlargement and foreign policy – slipping down the priority list. The only other issues of major note were the signing of the Croatian Accession Treaty and decisions on the EU's enlargement process regarding Serbia and Montenegro.

With respect to the sovereign debt crisis, the European Council dealt with the issue of treaty change, "qualitative moves" towards "a "fiscal stability union", a new fiscal impact, measures aimed to strengthen economic policy cooperation and coordination, the strengthening of the EFSF/ESM and increasing IMF resources, with these decisions set out in a statement by the 17 euro area heads of state and government.

'17 plus' or '27 minus' instead of treaty change

Prime Minister Cameron's refusal to accept treaty change without the concessions he demanded, which were strongly rejected by the vast majority of member states, meant that EU leaders could not strike a compromise on amending the Union's primary law, as a change in the Treaties would have required the consent of all EU governments – whatever procedure was chosen to do so.

The interim report ("Towards a stronger Economic Union") prepared by President Van Rompuy, in cooperation with Presidents Barroso and Juncker, and presented to governments two days before the Summit, included two options for changing the EU's primary law:

- Amending Protocol No 12, which covers the 'excessive deficit procedure' and is attached to the Treaty on the Functioning of the European Union (TFEU); *or*
- Reforming the EU Treaties (including Article 126 and 136 TFEU; and/or a revision of Protocol No 14 on the Eurogroup) via the revision procedures foreseen in Article 48 of the Treaty on European Union (TEU).

The first option had the advantage that treaty change would have been relatively swift and easy, as it would simply require a unanimous Council decision based on a proposal from the Commission after consulting the European Parliament (EP) and the ECB, and without ratification by member states. The second would have been more complex, as it would have either required both a convention and an intergovernmental conference (IGC) under the ordinary revision procedure, or an IGC only under the simplified revision procedure – although the decision not to hold an IGC in the latter case would have required the EP's consent.

Both options – Protocol 12 and Article 48 – required consensus among all EU governments. As a consequence of the British 'no', the Euro 17 opted for an international intergovernmental agreement outside the EU framework to be signed in March 2012 or earlier. The provisions included in this agreement shall, according to the Euro 17 statement, be incorporated into the Union Treaties as soon as possible.

Following the British 'no', the only alternatives open to the other 26 member states were either to abandon the idea of treaty change, which seemed impossible, especially given Berlin's insistence on amending the EU's primary law, or to postpone the amendment of the Treaties to seek a compromise with London, which would have enabled a treaty change at the level of 27 later on. But this did not appear to be viable either, for two main reasons: first, British objections to a treaty change seemed very strong unless Britain's demands were met -- and the other 26 governments would not give in to David Cameron's demand; and second, a delay would have sent a very negative signal, thereby further undermining market confidence.

But the summit did not only witness a political stand-off with the UK. In the run-up to the meeting, a majority of EU countries were either opposed or at least very hesitant about amending the Treaties, fearing this would take too long and could in the end even fail, with Dublin most concerned that treaty

change might trigger yet another referendum in Ireland. Consequently, most EU governments were attracted by the idea of amending Protocol 12, as this would not have required ratification.

A number of EU governments and the Commission also rightly argued that the Lisbon Treaty had not yet been fully exploited with respect to strengthening fiscal and economic governance. Others – especially in the EP – held that individual member states (including, most notably, France) had obstructed earlier attempts to secure fiscal discipline through a higher level of automaticity in the framework of the recent enhancement of the Stability and Growth Pact (SGP) through secondary legislation. In general terms, the EP maintained that substantial changes to the EU Treaties would require a European convention involving national and European parliamentarians and representatives of EU governments and the Commission.

Berlin and Paris argued in their joined letter to President Van Rompuy that certain fiscal reforms they were eager to implement (including the debt brake ('fiscal rule'), reverse majority) could not be put into effect without stronger commitments from member states enshrined in the EU Treaties. They pushed for a treaty change supported by all 27 EU countries, but also argued that an intergovernmental agreement outside the EU Treaties could be an alternative path.

Berlin was 'unhappy' that Van Rompuy's interim report did not elaborate on, or at least also refer to, the possibility of an intergovernmental treaty. Germany was strongly opposed to the idea of amending Protocol 12, arguing that in the current situation, this would be an inappropriate "legal trick". The severity of the crisis would, according to Berlin, require a more coherent and clear-cut solution ratified by all euro countries, thereby sending a strong signal to markets that the Euro 17 were committed to imposing a more rigorous fiscal regime.

Others, especially smaller EU countries and many MEPs, were (highly) critical of an intergovernmental arrangement between the Euro 17 for two key reasons:

Firstly, they feared this could (further) undermine the role of supranational EU institutions, although Berlin and others rightly argued that it would achieve exactly the opposite and that a strengthening of fiscal surveillance through a higher level of automaticity would in fact enhance the Commission's role. Secondly, a large number of smaller member states and the vast majority of non-euro countries feared that a Euro 17 treaty would widen the dividing lines between 'ins' and 'outs'.

This argument is certainly valid, but after the summit, EU leaders were keen to stress that the intergovernmental agreement between the Euro 17 will be open to all non-euro countries. Nine heads of state or government – Bulgaria, Czech Republic, Denmark, Hungary, Latvia, Lithuania, Poland, Romania, and Sweden – have indicated that they will probably take part in this process, but will have to consult their parliaments before taking a final decision. It seems highly likely that a vast majority of non-euro countries – maybe even nine out of ten – will in the end sign up to the intergovernmental treaty.

All this signals that the EU is not on the way towards a 'division of Europe' predicted by some. The picture is more complex. We already have different speeds, and yes, a deepening of cooperation and coordination among eurozone countries will create a higher level of integration. But this will not deepen the divide between 'ins' and 'outs' as long as the EU institutions remain involved and both sides have a strategic interest in gradually enlarging the euro zone – and this seems to be the case.

Assuming the euro survives the current crisis, it is very likely that in ten years' time, the euro area will include some of the countries that have not (yet) been able to join. The fact that some of them have joined the Euro Plus Pact (Bulgaria, Denmark, Latvia, Lithuania, Poland, and Romania), and that many now seem ready to sign up to the new intergovernmental agreement, is a strong signal that most non-euro EU countries want to abide by their treaty obligation to join the euro zone. The Euro 17 also have an interest in keeping the euro door open, as the currency's continued attractiveness will boost confidence among European citizens, investors and the outside world that the euro is here to stay.

Many details of the new intergovernmental agreement still need to be worked out, and a key set of questions need to be answered about the content, legal nature, and ratification/entry into force of the agreement; the affiliation of non-euro countries; the involvement of the EU institutions; and the eventual inclusion of the agreement in the EU Treaties:

- What elements and measures will have to be enshrined in an intergovernmental agreement and what can be done through secondary legislation? Will the former be confined to a (very) limited list of measures, including, for example, the compulsory application of the debt brake ('golden rule') in national law, the commitment by euro countries to apply the reverse majority rule in the excessive deficit procedure, and/or the numerical benchmark for debt reduction (1/20 rule)? Or will other elements need to be incorporated in the new treaty?
- What is the exact legal nature of the new intergovernmental agreement and how will it relate to the existing EU Treaties? Would the measures agreed by the Euro 17 be laid down in a treaty along the lines of the Schengen or Prüm Treaties, or could the individual elements be integrated into the ESM treaty, for which the Euro 17 have agreed an easier and earlier entry into force by July 2012 (see below)?
- How will the agreement be ratified in the Euro 17 countries and when will it enter into force? Will ratification require national referenda in one or more member states? EU leaders argue that the new agreement is in line with the existing Treaties and there is no further transfer of competences to the supranational level, which should allow countries to ratify it without holding referenda. However, the agreement could still face ratification problems in national parliaments. Thus, it is valid to ask whether the new treaty could enter into force even if some countries fail to ratify it. Some of these questions would be at least partially answered if the Euro 17 decide to integrate the new measures and commitments into the ESM Treaty, as Berlin appears to be suggesting – the summit decided that this treaty will enter into force in mid-2012 even if some member states have not ratified it by then. But if the Euro 17 decide to integrate the extra provisions into the ESM Treaty, how would that affect non-euro countries which are not subject to the ESM?
- How will non-euro countries that want to participate in the new construction be associated with the intergovernmental agreement? Will they be included as observers or be able to play a more active role in devising the accord? Will they be obliged to transpose certain elements such as the debt brake into national legislation? And how will the agreement affect the future integration of EU members into the common currency?
- How can EU institutions be involved in translating the individual measures and political commitments into practice? What role can and should EU institutions – including the European Council, Council (Eurogroup), European Commission, EP and European Court of Justice (ECJ) – play without running into legal conflicts with the existing Treaties? Will the new agreement require the establishment of new institutions/bodies separate from the current institutional structure? Governments strongly in favour of the '17 plus' agreement, such as Berlin, argue that the new arrangements will in fact strengthen the existing institutions (see above). But how will the EP be engaged in the process? Following a meeting of EU leaders with Parliament President Jerzy Buzek, both sides agreed that the EP would send observers to contribute to the elaboration of the new agreement. However, the Parliament feels sidelined and there is a need to clarify how MEPs will be involved in this process and in the implementation of the new accord. In more general terms, an intergovernmental agreement outside the treaty framework raises some fundamental questions related to broader considerations of democratic legitimacy both on the national and European level.
- When and how could the elements agreed in the intergovernmental treaty be incorporated into the EU Treaties at a later stage? The Euro 17 said they would try to do this as quickly as possible. But this could take a long time as it would require a treaty reform along the lines described e.g. in the interim report. Are there other ways to integrate the innovations into the EU Treaties, for example by (mis-)using future accession treaties?

The UK and the EU – redefining an awkward relationship

Beyond the more 'technical' questions surrounding the '17 plus' treaty, there is a much more fundamental political challenge, which the Union will have to deal with after this summit: the future relationship between the UK and the EU.

Prime Minister Cameron came to Brussels eager to send a message of strength back to his own party and to the British electorate. Under pressure from Eurosceptics in his own ranks he wanted to showcase that he had strongly defended British interests; that if he could not get "adequate safeguards" for the UK he would not agree to a treaty change. But was this really in the interest of the UK?

In the end, London found itself completely isolated. All the other 26 EU leaders opted for an intergovernmental treaty and no member state supported David Cameron's cause. He had overplayed his cards. Was this in the interest of the UK? No. Measures to strengthen economic and fiscal governance, which aim to help solve the euro crisis, are not only in the interest of those who have introduced the common currency. They are also in the interest of the United Kingdom, as Cameron himself had said prior to the summit, since a further deterioration of the crisis or maybe even a break-up of the euro zone would have vast negative economic effects in Europe and beyond. A long and enduring recession is definitely not in the interest of Britain, as its already struggling economy is closely interlinked with other European economies. The UK has thus a strong interest in overcoming the crisis, and obstructing ways to amend the Treaties point in the wrong direction.

In addition, the UK government should have been aware of the fact, that the other EU countries would not agree to changes undermining the common market and qualified majority voting in the Council is one of the cornerstones of the Single Market rulebook, which the other 26 could not put at risk. Nor could they understand the UK's aims, as Britain had traditionally supported the single market, including majority voting in this field originally negotiated by Prime Minister Margaret Thatcher in 1986.

But the showdown at the Summit was not in the interests of the other member states either. Disunity sends a negative signal to private investors and to other market players (many of them based in London!), who already doubt the EU's ability to master the sovereign debt crisis and the isolation of the UK could further increase these uncertainties.

A permanent isolation of London – one of Europe's largest economies and a significant foreign policy actor – is not in the interest of other EU capitals. Those who think that the UK does not really belong to the EU and that it would be best to 'get rid' of an "awkward partner" (to quote the title of Stephen George's famous book on the UK in Europe) should have no reason to be cheerful after this summit. The likelihood that Britain will leave the EU is marginal. The UK might want to re-define the country's relationship with continental Europe, but it will remain an EU member, even if the current government in London might attempt to loosen its ties with Brussels.

With respect to the future, it should be in the interest of both sides to reconcile their relationship. Much will depend on whether the British government will further undermine the implementation of measures aiming to deepen fiscal and economic integration in the euro zone. Strangely enough, it is possible that the incident at this summit might have a positive effect in this respect: the fact that Prime Minister Cameron publicly showcased his ability and readiness to 'protect' and 'defend' British interests might actually increase his political room of manoeuvre when it comes to EU affairs. On the other hand, it might whet the appetite of the Eurosceptics in his party to demand more. Other EU governments will be well advised if they reach out their hands and seek a compromise and maybe even a new *modus vivendi* between the UK and the Union – but this must at the end of the day suit the interests of both sides.

"Qualitative moves" towards a "fiscal stability union"

Although the summit was dominated by the treaty change issue, EU leaders took a number of more concrete decisions aimed at further enhancing fiscal and economic governance. Beyond the measures already agreed in the last 18 months (including the enhanced SGP, new macroeconomic imbalances procedure, introduction of the European Semester and the Euro Plus Pact), the Euro 17 statement calls for a "reinforced architecture" for the Economic and Monetary Union (EMU) which includes further "qualitative moves" towards a genuine "fiscal stability union" in the euro area.

EU leaders hope the introduction of a robust fiscal regime will send a strong signal to investors that the Union and its members are ready to do everything necessary to return to the path of fiscal virtue through more discipline, more ambitious sanctions and stricter surveillance. At a joint press conference with President Van Rompuy, President Barroso argued that the EU was now "much more ambitious" and this would help to overcome the lack of confidence, which – as he correctly argued – constitutes the core of the current crisis. Chancellor Merkel spoke of a "major breakthrough" on the way towards a stability union, which must be further developed in the years to come.

In more concrete terms and in line with the interim report as well as the Franco-German letter, euro leaders agreed on a so-called "fiscal compact" and on measures aimed at stronger coordination of economic policies in areas of common interest.

The fiscal compact

The fiscal compact will rest on three key elements: the introduction of a new fiscal rule in all euro countries; a higher level of automaticity with respect to enforcing the rules governing the excessive deficit procedure for euro countries (Article 126 TFEU); and a swift examination of the new rules for the Stability and Growth Pact proposed by the Commission on 23 November.

Introduction of a new fiscal rule

The Euro 17 committed themselves to the following three innovations:

- All euro countries will introduce a *fiscal rule* ('golden rule') requiring general government budgets to be balanced or in surplus. Following the German *Schuldenbremse's* example, the debt brake will have to be introduced into national legal systems at "constitutional or equivalent level". Aiming to define the fiscal rule more concretely to guarantee a more uniform application in all member states, the Euro 17 said this principle will be deemed to have been respected if the annual structural deficit does not exceed 0.5% of nominal GDP. The structural deficit is the portion of a country's budget deficit that does not result from changes in the economic cycle; i.e. a structural deficit occurs when a country posts a deficit even when the economy is operating at its full potential. In effect, this means that a country's actual deficit might well exceed 0.5%.
- Member states in excessive deficit procedure will submit a binding *economic partnership programme* detailing the necessary structural reforms to ensure an effective and durable correction of excessive deficits. This will have to be endorsed and its implementation monitored by the Commission and Council. Member states shall converge towards their specific reference levels according to a timetable proposed by the Commission.
- Aiming to provide a more transparent overview, the Euro 17 have agreed to create a mechanism for the *ex ante* reporting of their national debt issuance plans (but this is not linked to a collateralisation of sovereign debt and is not a step in this direction).

On the debt brake, the euro leaders' statement includes a reference to the ECJ: it states that EU leaders "recognise the jurisdiction" of the Court to "verify the transposition" of the new fiscal rule at national level. However, there are still some legal doubts as to whether the ECJ can be called on to do this if it is 'merely' laid down in an intergovernmental agreement; i.e. without an explicit reference to the fiscal rule in the EU Treaties. Berlin and others, however, rightly argue that such a procedure

would be in line with Article 273 TFEU, which specifies that the Court has jurisdiction in any dispute between member states which relates to the subject matter of the Treaties, if the dispute is "submitted to it under a special agreement between the parties".

It is also worth mentioning that earlier calls, especially from Berlin, for the ECJ to judge whether member states are implementing the SGP's new rules correctly are not mentioned in the Euro 17 statement. This was a concession to Paris, which strongly opposed giving the Court the power to impose such sanctions, as this would have implied a substantial transfer of national sovereignty. Hence, the ECJ will not be called to rule on national budgets and thus will not be able to annul them.

In more fundamental terms, there are two key questions about the new fiscal rule which need to be answered. First, will the debt brake work in practice? The ECJ might be able to verify whether the fiscal rule has been 'correctly' inserted into national law, but will it really prevent governments from overspending? Second, and even more importantly, is fiscal discipline measured in terms of public deficits really the key to avoiding similar crises in future? An analysis of deficit developments in EU countries before the crisis (1999-2007) indicates that most countries (except Greece) fell below the 3% threshold over that period. The worst performers included Italy, France, Germany and Austria, while Ireland, Estonia, Spain, and Belgium did relatively well. So is the deficit level really the right indicator?

Yes, the sovereign debt crisis has proven that greater fiscal discipline is necessary and every country must be compelled to enter the path of fiscal virtue. But the crisis has taught us more than that: the increasing economic divergence and disparities within the euro zone, the loss of competitiveness in many countries on the EU's periphery and the increase of competitiveness of core eurozone countries, has significantly contributed to the current crisis. Rising current account deficits in countries such as Estonia, Portugal, Greece, Spain, Ireland and Italy have pushed these countries into the epicentre of the euro crisis. This is why these countries, unable to devalue their national currency, have to implement major structural reforms to increase their competitiveness, which is indispensable if they want to (eventually) grow out of their problems.

If one follows the above logic, the key economic challenge and dilemma can be reduced to the following 'simple' question: how can austerity and growth be pursued simultaneously? On the one hand, there is an undisputed need to cut public deficits and the overall level of public debt, especially in countries that have reached (or are about to reach) unsustainable levels beyond 100% of GDP. On the other hand, continuous austerity has negative effects on growth, which in turn worsens the problems in countries most affected by the crisis, with public spending cuts contributing to prolonged and deep recessions.

The strong emphasis on fiscal discipline and austerity in the last 18 months and at last week's summit is justified, but needs to be balanced by a greater emphasis on measures and innovative policy choices aimed at fostering structural reform and stimulating growth throughout Europe. Obviously, the latter is much more difficult, but concentrating solely on fiscal discipline will not get EU countries and the euro out of the crisis.

Higher level of automaticity and numerical benchmarking

Largely in line with the interim report, euro-area countries have committed themselves to introducing a higher level of automaticity in enforcing the excessive deficit procedure rules. When a member state breaches the 3% ceiling, there will be automatic consequences unless a qualified majority of euro countries are opposed to such measures (the reverse majority rule). Subsequent concrete steps and sanctions proposed or recommended by the Commission will be adopted unless a qualified majority is opposed. This will thus strengthen the Commission's ability to put pressure on Member states to obey the rules enshrined in the SGP.

The introduction of the reverse majority rule will require a change to the rules enshrined in Article 126 TFEU on the excessive deficit procedure, which now have to be laid down in the framework of the new intergovernmental treaty as a binding commitment by the Euro 17.

The introduction of higher levels of automaticity is in line with the Franco-German agreement set out in Chancellor Merkel and President Sarkozy's joint letter to President Van Rompuy. By agreeing to the introduction of the reverse majority rule, Paris has moved away from its original position. It had been strongly against more automatic procedures, which reduce the ability of governments to prevent disciplinary measures 'dictated' by Brussels. But despite this concession, Paris still remains reluctant, fearing that fiscal rules might become too rigid and not leave room for governments to adjust to shocks and that 'excessive austerity' could in the end throttle growth.

In addition to more automaticity, the Euro 17 also agreed that the specification of the debt criterion in a numerical benchmark for debt reduction (1/20 rule) for member states with government debt in excess of 60% needs to be enshrined in the provisions of the intergovernmental treaty.

Swift examination of Commission proposals

The Euro 17 leaders declared that they will swiftly examine the new rules proposed by the Commission in two draft regulations which would apply to the euro countries (on the basis of Article 136) and add to the existing SGP rulebook. They called on the Council and EP to examine these regulations rapidly so that they can enter into force for the next budgetary cycle in 2012.

The proposed regulations aim to transform into law the agreement reached by the October Summit concerning (i) the monitoring and assessment of draft budgetary plans, and correction of excessive deficits in euro-area member states; and (ii) the strengthening of economic and budgetary surveillance of countries experiencing or threatened with serious difficulties with respect to their financial stability.

The first regulation would require euro-area countries to present draft budgets at the same time each year and give the Commission the right to assess and, if necessary, issue an opinion on them. The Commission could request that these drafts be revised, if it considers them seriously non-compliant with SGP obligations. The regulation also proposes closer monitoring and reporting requirements for euro-area countries in excessive deficit procedures. Finally, euro countries would be required to establish independent fiscal councils and to base their budgets on independent forecasts.

The second regulation aims to strengthen the monitoring and surveillance procedures even further for euro countries experiencing severe difficulties or in receipt of financial assistance. These countries will be subject to tighter monitoring ("enhanced surveillance") by the Commission – in liaison with the ECB. On the basis of this monitoring, the Commission may conclude that further measures are required by a member state and that its financial situation is having a significant adverse effect on the financial stability of the euro area. If so, the Commission may propose that the Council recommend that the member states concerned has to seek financial assistance and that a macro-economic adjustment programme be prepared. This would effectively compel the country concerned to ask for external help.

Both pieces of secondary legislation would further strengthen the fiscal regime for euro-area countries, going significantly beyond the current rules laid down in the already enhanced SGP.

Strengthened economic policy cooperation and coordination

Beyond the fiscal compact, euro leaders also decided on measures to further enhance economic policy coordination through an increased use of the instrument of enhanced cooperation and the introduction of a new procedure to discuss major policy reforms.

Increased use of enhanced cooperation

In line with both the interim report and the Franco-German letter, euro leaders have committed themselves to make more active use of enhanced cooperation on matters which are "essential for the smooth functioning of the euro area", without undermining the Internal Market.

Enhanced cooperation is a general instrument of differentiation originally introduced by the Amsterdam Treaty and then modified by the Treaty of Nice and the Lisbon Treaty. Enhanced cooperation is a last-resort mechanism which can be initiated when the Council "has established that the objectives of such cooperation cannot be retained within a reasonable period by the Union as a whole" (Art. 20 TEU). It allows a minimum number of states (nine, according to the Lisbon Treaty) to cooperate more closely on the basis of a clear set of preconditions, rules and procedures concerning the authorisation, operation and widening of cooperation.

Unlike both the Franco-German letter and the interim report, the Euro 17 statement does not include a specific list of policy issues to which enhanced cooperation could be applied. However, the interim report and the Franco-German letter give an indication of potential areas: the interim report mentions the functioning of labour markets, sustainability of pensions and social security systems; the Franco-German letter mentions even more specific areas including financial regulation and convergence or a harmonisation of the corporate tax base.

Nor does the Euro 17 statement take up another idea contained in the interim report, namely a more automatic procedure for authorising the initiation of enhanced cooperation similar to the 'automatism' included in the Lisbon Treaty for judicial cooperation in criminal matters, police cooperation and the establishment of a European Public Prosecutor's Office. In these areas, the authorisation to proceed with enhanced cooperation is granted automatically on the basis of a clearly defined procedure, which makes moving to enhanced cooperation much easier. However, such a reform would have necessitated an amendment of the current Treaties.

The use of enhanced cooperation would certainly increase the level of differentiation with the EU-27, but it would do so within the treaty framework and on the basis of a (rather) clearly defined instrument. Enhanced cooperation would follow a 'functional-pragmatic logic' based on a case-by-case approach aimed at overcoming specific blockages by certain member states which are either unwilling or unable to cooperate more closely. A key characteristic of enhanced cooperation is that it is open to all EU member states, thus allowing both euro and non-euro countries to participate.

Procedure to discuss major policy reforms

Besides enhanced cooperation, the Euro 17 want to establish a procedure to ensure all major economic policy reforms planned by euro countries are discussed and coordinated with a view to benchmarking best practices. The exact details of this procedure have yet to be worked out, but additional euro summits could be used to discuss specific policy issues and best practices. The Franco-German letter suggested monthly meetings of the Euro 17 as long as the crisis lasts. These could be used to discuss major national policy reforms and exchange best practices on, for example, tackling youth unemployment, pension reform or innovation policy. But these summits should be open to those non-euro countries that have signed up to the Euro Plus Pact and/or the new '17 plus' agreement.

Strengthening the EFSF/ESM and increasing the IMF's resources

Besides measures intended to reinforce the EMU's architecture, the Euro 17 also agreed a number of more immediate issues related to strengthening the EFSF/ESM and increasing the IMF's resources.

Reform of the EFSF/ESM

The measures related to both the EFSF and ESM include a more rapid deployment of EFSF leveraging; an earlier and easier entry into force of the ESM treaty; a prolongation of the EFSF; a quicker phasing-in of paid-in ESM capital; the (non-)involvement of the private sector in any debt restructuring; and a reform of the voting rules in the ESM.

- *Rapid deployment of EFSF leveraging:* Euro leaders agreed that the two leveraging options – the insurance model and the co-investment fund – agreed by the Eurogroup on 29 November will be deployed as rapidly as possible. It now seems likely that leveraging will have less of an impact than previously expected. Realistic estimates hold that the leveraging effects could multiply the remaining EFSF liquidity by two to three times, implying that the EFSF's liquidity net will be below €1000 billion and thus too small to 'cover' the vast borrowing needs of countries such as Italy or Spain. The ECB's readiness to provide its market expertise to the EFSF could help the Facility to identify ways to use available resources more efficiently (the cooperation between the ECB and the EFSF was agreed on the first day of the Summit, when ECB President Draghi met EU leaders).
- *Earlier and easier entry into force of ESM:* Aiming to send a signal to 'markets', the Euro 17 decided that the ESM treaty should (if possible) enter into force one year earlier than originally scheduled, i.e. in July 2012. Experts are still working out the final details of this treaty, which then has to be signed and ratified. Going beyond the interim report, the ratification 'danger' has been reduced as the Euro 17 have agreed that the Treaty will enter into force as soon as it has been ratified by member states representing 90% of the capital commitments. The individual capital commitments are calculated on the basis of the ECB key, so the ESM Treaty could enter into force even if a number of euro countries do not ratify it (as an indication: the nine euro countries with the smallest proportion of ECB paid-up capital cumulatively account for less than 10%). The 90% rule will further increase pressure on eurozone countries to ratify the ESM treaty and sends a positive signal to investors as it reduces the risk that the ESM might never enter into force. Finally, the ESM Treaty's earlier and easier entry into force is particularly significant if it is used to include those measures and commitments which the Euro 17 have agreed to incorporate into an intergovernmental treaty (see also above). This would not only make those elements binding by mid-2012, but it would also reduce the risk of the additional measures and commitments not entering into force due to ratification problems in one or other country.
- *Prolongation of the EFSF:* Euro leaders have decided that the EFSF will remain active in financing programmes already begun until mid-2013 and will "continue to ensure the financing of the ongoing programmes as needed". There has been speculation that this might imply that the EFSF funds used to support programme countries would increase the overall size of the liquidity net provided by the EFSF and ESM. However, the Euro 17 statement mentions that the overall ceiling of the EFSF/ESM will remain at €500 billion, but that the overall ceiling will be "reassessed" in March 2012, leaving the door open for a potential increase of the total liquidity net.
- *Quicker phasing in of ESM paid-in capital:* Euro leaders decided that member states would stand ready to "accelerate payments of capital" to maintain a minimum 15% ratio between paid-in capital and the outstanding amount of ESM issuances. Earlier this year, euro governments decided that the ESM's effective lending capacity of €500 billion would be achieved through a combination of €80 billion of paid-in capital, which will be phased in from the ESM's entry into force in five equal annual instalments, and €620 billion of call-able capital and guarantees from eurozone members. The prospect of a more rapid phasing-in gives a signal to investors that the ESM could run at full speed earlier if need be.
- *Change in ESM voting rules:* To avoid potential blockages and in line with IMF practice, euro leaders have decided to change the ESM voting rules by including an "emergency procedure", which would replace the mutual agreement rule (i.e. unanimity) by a qualified majority of 85%. The relevant paragraph in the agreement between the Euro 17 includes a footnote specifying that the adaptation of the voting rules is still subject to confirmation by the Finnish parliament. The application of the emergency procedure would imply that smaller member states would not be able to veto key decisions, but the summit agreement includes a safeguard: the emergency procedure

will only apply if the Commission and ECB conclude that "an urgent decision related to financial assistance is needed", i.e. when the financial and economic sustainability of the euro area is threatened. In any case, one should not forget that as a general rule, the ESM will only be used as an *ultima ratio*; i.e. it will provide financial assistance only if this is deemed indispensable to safeguard the stability of the euro as a whole.

- *Private-sector involvement*: Finally, the 17 euro leaders backtracked from original provisions concerning public sector involvement (PSI) in the event of a potential debt restructuring inside the euro zone. The ESM Treaty preamble will now include a provision that the ESM will adhere to "well-established IMF principles and practices", designed to signal to investors that there is no specific 'lex Europea'. This reflects a recognition that inserting a special insolvency procedure into the ESM treaty and the decision to restructure Greek debt had adverse effects, provoking uncertainty among private investors as to whether other euro countries would eventually have to follow suit. In other words, it shows that the doubts about private-sector involvement were justified and the euro leaders' willingness to correct their mistake is a positive development. But it will not be easy to allay investors' fears that other euro countries might also have to restructure their debt, even if the ESM will now follow IMF principles and even if EU leaders have repeatedly declared that the restructuring of Greek debt is a "unique and exceptional" case. The genie is out of the bottle and private investors will remain sceptical that their investment in sovereign bonds is 'safe'. Some eurozone leaders, especially in creditor countries, will have to face tough questions from those who fought hard for a PSI and for the inclusion of an orderly default procedure in the ESM Treaty. However, they will be able to argue that the Euro 17 have not abandoned the decision to insert Collective Action Clauses (CACs) into sovereign bonds issued after the ESM enters into force. These CACs will enable creditors to agree by qualified majority on a legally-binding change to the terms of payment (standstill, maturity extension, interest cuts and (or) haircuts). The Euro 17 statement explicitly states that CACs will be included in such a way as to preserve "market liquidity"; but it is still unclear what this will mean in detail.

Strengthening the IMF's capital resources

To ensure that the IMF has "adequate resources" to deal with the crisis, the Euro 17 have confirmed that they are ready to increase those resources. In line with decisions taken at an EU summit end October, at the Cannes G20 Summit in November and in the framework of the Eurogroup, leaders have declared that the euro area and other member states will consider providing up to €200 billion extra. This sum, which will include up to €150 billion from euro countries plus up to €50 billion from non-euro countries, will come from bilateral loans, which have to be confirmed within ten days of the end of the Summit. It is not yet clear where these resources will come from – i.e. from state budgets and/or from national central banks. In any case, EU countries hope that additional contributions will also come from the international community. Non-EU countries and central banks have cautiously indicated their potential readiness to provide the IMF with extra funding, but these resources would not be 'free'; those providing additional liquidity will ask for political, economic and other concessions in return.

There are a number of reasons why euro leaders decided to use the IMF instead of increasing the firepower of the EFSF/ESM. First, the IMF is more experienced in managing assistance and more capable of linking assistance to certain conditions which the beneficiary country has to meet. Second, by going through the IMF, governments and central banks avoid getting into conflict with legal provisions which prevent them from providing direct assistance to eurozone countries. Third, increasing the liquidity of the EFSF/ESM is politically more delicate and more difficult as (most) governments have to ask their parliaments.

The important "non-issues"

Besides the above mentioned decisions, measures and commitments, it is equally important to note a number of significant issues which did not find their way into the agreement between the Euro 17. There is no reference to (i) Eurobonds or Stability Bonds; (ii) providing the ESM with a banking licence; or (iii) recapitalising banks through the ESM.

No reference to Eurobonds or Stability Bonds

Unlike the interim report, the Euro 17 statement does not include any reference to measures aimed at a collateralisation of sovereign debt inside the euro zone. The interim report included a very carefully worded reference to some form of Eurobonds/Stability Bonds, arguing in favour of "opening up the possibility, in a longer term perspective, of moving towards a common debt issuance in a staged and criteria-based process". This reflected the fact that a vast majority of governments, the Commission and EP either strongly support, or at least are open to, some form of collateralised debt.

Berlin is strongly opposed to this, although key representatives of the government, including Finance Minister Wolfgang Schäuble and even Chancellor Merkel, have never totally closed the door to some form of collateralisation at a later stage, if and when the EU or the euro area has established some form of fiscal union. The interim report acknowledged this by arguing that any such steps must be "commensurate with a robust framework for budgetary discipline and economic competitiveness to avoid moral hazard". When the Commission presented its Green Paper on Stability Bonds (which includes an entire section on moral hazard) on 23 November, it also proposed two regulations aimed at increasing the oversight of national spending (see above), hoping that all EU members would approach the issue, in President Barroso's words, with an "open mind" that is "free of dogma".

But none of this convinced the German coalition government, which still feels that a collateralisation of debt would not solve the current problem and would send the wrong signal to those member states that have to further reduce spending and introduce structural reforms. Berlin is not (yet) ready to (publicly) acknowledge that indicating the possibility of introducing some kind of collateralised debt in future could send a signal to market players that current and future euro members are ready and willing to tie themselves together more closely than in the past, which could help increase the confidence in the future of the common currency.

No reference to a banking licence

The Euro 17 statement does not include any reference to the idea of providing the EFSF or the future ESM with a banking licence, which would allow it to tap into ECB liquidity. This proposal had been strongly promoted by France and other euro area governments facing the risk of contagion and the interim report includes a very vague reference to this, by stating that the ESM could have the "necessary features of a credit institution". However, a number of member states (including Germany, Austria, Finland and the Netherlands), the ECB and the EFSF are opposed, arguing that this would constitute a breach of EU law (Article 123 TFEU). However, the debate over this continues.

No recapitalisation of banks through ESM

Again unlike the interim report, the Euro 17 statement does not take up the idea of making it possible for the ESM to directly recapitalise banks. The current compromise only foresees the possibility that the rescue fund might be asked to provide loans to member states that are themselves unable to assist their banks. There is no agreement to provide liquidity to banks directly through the EFSF or ESM.

A final assessment – the 'prize' goes to: the ECB!

The 8-9 December EU summit sent very mixed signals to policy-makers, commentators, experts, citizens, and, last but not least, investors. It is very difficult to assess its outcome or impact on the crisis, although there was some concrete progress in certain important areas related to the future governance of the euro zone and the more immediate tools to manage the crisis.

In more general terms, there has been one fundamental positive development: a growing realisation that the crisis is predominantly one of confidence in the EU and the future of the euro. As a consequence, previous and new elements of the crisis recipe have to be (re)assessed to see whether they undermine or contribute to efforts to regain trust and confidence. The readiness of EU

governments and institutions to admit and correct mistakes is an important step in the right direction. The recognition that involving the private sector in restructuring debt sent damaging signals to private investors, the decision to introduce more majority voting in the ESM to enhance its efficiency and effectiveness, the readiness to put the ESM in place earlier, the willingness to strengthen the Commission's role in the framework of a fiscal union, and the readiness to speed up the establishment of the permanent stability mechanism, are all signs that investors will take notice off.

However, three other developments are less promising. First, recent polls indicate that a vast majority of citizens in both stronger and weaker EU countries have lost confidence in the 'European project' – and some elites seem to share this judgement. Second, the increasing distrust between EU capitals, between different groupings ('ins' vs 'outs'; 'big' vs 'small'; 'lenders' vs 'creditors' etc.), and between Brussels institutions and (some) national capitals. Third, the inability to strike the right balance between austerity and growth, between the undisputed necessity to reduce deficits/debts and the need to effectively counter the increasing economic divergences between EU countries.

This summit was not a 'major breakthrough'. It is not likely to go down in the history books as the European Council which turned the tide. It is more likely that the EU will remain in 'crisis mode' for some time to come. Markets are not likely to calm down; confidence and trust will not return quickly. The summit demonstrated once more that the EU is on a long and bumpy road and it is impossible to be sure which phase of the crisis we are in. What (almost) everyone now seems to acknowledge is that this is a systemic crisis, which threatens not only the EU's periphery but the very foundations of European integration. It might sound strange, but this is good news, because it compels everyone to keep on moving, although at times it seems as if the EU has lost its sense of direction in the absence of a guiding map.

Nobody should have expected that EU leaders could come up with a silver bullet – or 'bazooka', as it is often called these days. However, the European Council, and especially the leaders of the euro zone, took a number of noteworthy decisions both negative and positive.

On the negative side, one can list the following: the political stand-off with, and isolation of, the UK; the inability to find an agreement 'at 27' to amend the Union's primary law; the fact that '17 plus' were compelled to move towards an intergovernmental agreement outside the EU Treaties; the many uncertainties surrounding the elements, the set-up, the future, and the legal, institutional and political consequences of such an agreement; the EU's seeming incapacity to reform itself in the framework of a European convention including elected parliamentarians; the question mark over whether the new fiscal rule (debt brake) will actually work in practice; the fact that most rescue efforts (still) concentrate on fiscal discipline and not on finding the right balance between austerity on the one side and measures aimed to foster structural reform and growth throughout Europe on the other; the fact that it will be difficult to regain the trust of investors with respect to euro-denominated bonds even if the ESM follows IMF principles when it comes to debt restructuring; the continuing lack of a liquidity net big enough to calm markets; the fact that the EU and its members cannot solve problems on their own but have to go to the IMF and other international players (BRICS, the US, Gulf countries etc.) to seek assistance; and, finally, the inability of the Euro 17 to reach a compromise on an eventual (partial) collateralisation of sovereign debt, which would have been seen as a sign of unity and determination that euro countries are ready to do whatever is needed to safeguard the euro and that the common currency is here to stay.

One can mention an equally long list on the positive side: the fact that EU leaders were in the end able to overcome their differences and (at least) strike a compromise on a number of significant issues; that the Euro 17 found an alternative solution to treaty change, which promises quite a quick implementation; that the intergovernmental treaty is open to all EU members and a vast majority of non-euro countries (maybe even nine out of ten) seem ready to sign up to it; the pledge to integrate the elements of the '17-plus' treaty into the EU Treaties as quickly as possible; the aspiration that this agreement will not lead to the creation of new bodies or institutions and will in effect strengthen the Commission; the fact that the EP will at least be able to contribute to the elaboration of the new agreement; the commitment by the Euro 17 to further reinforce the architecture of EMU by adding

significant elements to the puzzle of enhanced economic governance; the introduction of a new fiscal rule (debt brake) in national law subject to ECJ control; the commitment to introduce the reverse majority rule in the excessive deficit procedure; the agreement to swiftly examine the two regulations recently proposed by the Commission adding important elements to the existing SGP rulebook; the commitment to make more active use of the instrument of enhanced cooperation to overcome blockages by individual EU members on specific policy questions; the rapid deployment of EFSF leveraging; the earlier and easier introduction of the ESM Treaty; the readiness to accelerate the payments of capital to the ESM; the partial introduction of qualified majority voting in the ESM; the revision of the rules governing private-sector involvement in cases of debt restructuring in line with IMF practices; and, finally, the readiness to increase IMF resources by up to €200 billion.

The above lists of positive and negative outcomes of the summit show that this gathering of EU leaders once again produced a long but very mixed balance sheet. But the most important question being asked in the run-up to and after this European Council – i.e. whether the EU will be able to contain the euro crisis – will not be decided in Brussels or in any other EU capital: it will be decided in Frankfurt.

The crisis has reached a level where an even stronger involvement of the ECB has become essential. The solutions identified and decisions taken at the summit are insufficient and will take time to implement, but we have run out of time. True, the ECB cannot and should not take on the responsibilities of national governments and it must be very not to send wrong signals to governments, which could undermine their efforts to reduce deficits/debt and implement structural reforms. However, in the current situation, the ECB is the only EU institution credible and powerful enough to stop the downward spiral.

For this, the ECB could extend its securities markets programme and purchase even more sovereign bonds on the secondary market, beyond the approximately €200 billion already acquired since the escalation of the crisis in 2010. It could also provide loans/funding to international financial institutions like the IMF, which in turn could use these additional resources to assist euro countries under severe market pressure. The ECB could even define a maximum level of debt yields, guaranteeing viable interest rates for new debt issued by euro countries struggling in the markets.

In any case, the ECB must effectively act as 'lender of last resort' at least until more permanent and credible arrangements are in place. Yes, this would increase inflation risks in the euro zone. But maintaining price stability with a fragmented currency will not be possible either, and in any case, inflation is not the immediate challenge, especially since all signs suggest that Europe is likely to suffer another economic downturn and may even move back into recession. More importantly, a higher inflation rate would be justified if it were to contain the crisis and ultimately avert the danger of implosion.

It is still possible to avert meltdown and this European Council might have increased the chances that the worst scenario can be avoided, but at a price. Not only will eurozone countries have to continue working in the direction of 'more Europe' – both in terms of enhancing EMU governance and reducing public debt – but they will also have to allow the ECB to step in and prevent collapse.

This is a hard ask, but the alternative is infinitely worse. The fact that President Draghi, as he left the summit, said the decisions taken by EU leaders were a "very good outcome for the euro area", "quite close to a good fiscal compact", and "very helpful in the present situation", could be interpreted as a positive signal from the new ECB President. The coming weeks and months will show how far the ECB is willing to go. In any case, Frankfurt will only be able to buy the EU more time. Governments must continue to do their 'homework' on the national and the European level, and future (euro) summits will continue to deal with the crisis.

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