

Stepping stone to an ambitious deal? – the results of an ‘intermediate summit’

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Summary

The October European Council was a relatively drama-free stepping stone on the way to a much more decisive meeting of EU leaders in December. Almost three years after the outbreak of the crisis, the prospects for the euro zone’s future look much more promising today than they did before the summer, but this Post-Summit Analysis by Janis A. Emmanouilidis warns that the easing of tensions on the financial markets is a mixed blessing. On the one hand, the crisis has pushed governments to do things which seemed impossible only a few years ago; on the other, there is a constant fear that the ‘crisis snowball’ could eventually trigger a financial, economic, social and political avalanche big enough to bury the European project. The biggest risk now is complacency: the EU needs to sign up to an ambitious and detailed agenda for a ‘Genuine Economic and Monetary Union’ in December.

Full report

The EU Summit of 18-19 October was an unspectacular and unambitious European Council that will not find its way into the history books. Unlike many of the ordinary and extraordinary gatherings since 2010, this was a relatively drama-free meeting and was not dominated by immediate fears about a potential worsening of the eurozone crisis. It was an ‘intermediate summit’ on the road to a much more decisive meeting of EU leaders in December, when key decisions related to both the more immediate and long-term future of economic, fiscal and (ultimately) political integration will have to be taken – provided that the discussions about the future of EMU will not be negatively overshadowed by deliberations on the Multiannual Financial Framework (MFF).

Two main issues linked directly or indirectly to the euro crisis dominated the Summit agenda: (i) the move towards completing Economic and Monetary Union (EMU) and, especially, the setting up of a ‘single supervision system’ (SSM) in the context of a banking union; and (ii) an evaluation of progress achieved in the framework of the so-called ‘Compact for Growth and Jobs’.

Other issues on the agenda, discussed on Day Two of the Summit, related to EU external relations: (1) EU leaders had an exchange of views on the Union’s relations with its **strategic partners**, and especially the perspectives for relations with **China**; (2) the European Council discussed the deterioration of the situation in **Syria** and *inter alia* endorsed the Foreign Affairs Council’s decision regarding restrictive measures against the Syrian regime and its supporters; (3) EU leaders expressed their serious and deepening concerns over **Iran**’s nuclear programme and confirmed their determination to increase pressure on Tehran in the context of the dual-track approach; (4) the European Council expressed its serious concern over the continuing political, security and humanitarian crisis in **Mali**; and, last but not least, (5) EU leaders expressed their gratitude for the decision to award the **Nobel Prize for Peace** to the EU, and said European Council members regarded it as their “personal responsibility” to ensure that Europe remains a “continent of progress and prosperity”.

The Summit’s key outcome can be summarised thus: many issues on the path towards an ‘EMU 2.0’ remain open, and key decisions will have to be taken at the 13-14 December European Council, when

EU leaders are expected to endorse a roadmap laying down the process and concrete steps for a further deepening of economic, fiscal and political integration.

The only concrete decision taken at this Summit related to the creation of a European banking supervisor based at the European Central Bank (ECB) as part of attempts to establish an integrated financial framework. Going beyond the June Summit, EU leaders decided that a “legislative framework” should be agreed by 1 January 2013. However, many issues related to the new single supervision system remain unresolved, and it is still uncertain when and to what extent the Union will be able to break the vicious circle between banks and sovereign debt effectively.

As expected, progress on creating an integrated budgetary and economic policy framework was limited. However, two interesting ideas worth further exploration were put forward and discussed: (i) the establishment of a new “fiscal capacity”, which could become a useful financial instrument to incentivise and support structural and public finance reforms, especially in the crisis countries; and (ii) the proposal that member states could conclude contractual arrangements with the EU institutions to promote the implementation of structural reforms, which could be financially supported by the new fiscal capacity.

There was no in-depth discussion of the German proposal to create a ‘Super Commissioner’ able to veto national budget plans and, as expected, no progress on limited/partial debt collateralisation. Developments regarding the Compact on Growth and Jobs, which in principle points in the right direction, has also been relatively limited in recent months, as member states have not done enough to implement many of the items on the long and ambitious list of measures required.

The overall situation ahead of the Summit

In contrast to the June EU Summit, which took place in ‘deep crisis mode’, the October European Council was held under much better conditions. Almost three years after the beginning of eurozone crisis, the prospects for the common currency look brighter than they did a couple of months ago, for three key reasons:

- The ECB’s decision in August/September to purchase sovereign bonds in secondary markets under certain conditions, attached to a programme supported either by the European Financial Stability Facility (EFSF) or the European Stability Mechanism (ESM), has eased market tensions significantly. Spanish and Italian spreads have fallen considerably and investors seem convinced that the ECB is ready and willing to use the ‘Outright Monetary Transaction’ (OMT) programme if need be.
- The willingness of the EU and its members to address EMU’s remaining structural deficits has increased confidence that governments have understood that the Union requires even more fundamental reforms. The readiness to launch a concrete process aimed at gradually establishing a ‘Genuine Economic and Monetary Union’ on the basis of four main building blocks – an integrated financial framework (‘banking union’); an integrated budgetary framework (‘fiscal union’); an integrated economic policy framework (‘economic union’); and democratic legitimacy and accountability (‘political union’) – is perceived as a sign that the EU, and especially the countries of the euro zone, are ready to do what is needed to overcome the crisis.
- Greater confidence that the euro zone will not fall apart and that member states will – out of “enlightened self-interest”, as Italian Premier Mario Monti put it – do their utmost to keep every country in the euro area, provided that the country concerned demonstrates its commitment to do whatever is needed to remain within the common currency.

All this has, at least for the time being, reduced the danger of a systemic meltdown. However, the crisis is by no means over; it has ‘merely’ moved from a very ‘hot’ to a cooler phase. The situation remains fragile, as many uncertainties and

dangers threaten to undermine efforts to regain confidence: the situation in the European banking sector remains highly dangerous; the 'Spanish question' has not yet been resolved; the Greek crisis is still looming; other countries including Cyprus and maybe even Slovenia might have to ask for a rescue programme; the socio-economic situation is worsening in many member states; and, more fundamentally, the 'collateral damage' caused by the crisis – nationalism, populism, separatism, political extremism, etc. – is escalating.

But paradoxically, the biggest danger stems from the fact that the crisis appears less critical today than it did only a couple of months ago. Complacency threatens to undermine the progress achieved, heralding the risk that governments will run out of steam in the weeks, months and years to come. In this situation, the EU needs to find a way to commit the member states and EU institutions to remaining sufficiently ambitious without the constant pressure of an escalating crisis, which could – if things move in the wrong direction – still spiral out of control and push the euro and the EU close to the abyss (for ideas on how to tackle the danger of complacency, see the final section of this paper).

EMU 2.0 – incremental steps in the right direction

It was against this backdrop that EU leaders arrived in Brussels for the October European Council. EU leaders' discussions on Day One focused on the future of Economic and Monetary Union. In the words of European Council President Herman Van Rompuy, the major aim was to "clarify new concepts" and "test the degree of support for various ideas" on the basis of the interim report he had prepared in collaboration with the European Commission, European Central Bank and Eurogroup presidents.

Almost all the elements in the report are still subject to intense discussions between EU capitals. Major differences remain. It is worth taking a detailed look at each of the four building blocks – the integrated financial, fiscal and economic policy frameworks, and the issue of democratic legitimacy and accountability – and analysing the most contentious, prominent and interesting questions they raise.

1. Integrated financial framework – questions and uncertainties

With respect to the first building block, the Summit debate concentrated on the creation of a 'single supervision mechanism' (SSM) as a key element of a future banking union. After long and heated discussions, which ended late in the night and thus well beyond the originally foreseen schedule, EU leaders agreed on a timetable for setting up an ECB-based European banking supervisor.

Adding flesh to the bones of decisions taken at the June Summit, the Conclusions of this European Council invite legislators to proceed with work on the "legislative proposals" for the SSM as a "matter of priority", with the aim of agreeing the "legislative framework" by 1 January 2013 – a compromise that President Van Rompuy argued was the most significant achievement of this Summit. The Eurogroup and the ECB will now have to focus on the details, and "work on the operational implementation will take place in the course of 2013".

The agreement came after a public standoff between François Hollande and Angela Merkel. The French President (supported by many EU capitals and the European Commission) was demanding quick action, signalling his frustration with Germany's emphasis on longer-term reforms. The German Chancellor, on the other hand, warned that overly-hasty decisions would not strengthen but rather undermine market confidence if the new ECB-based supervisory system did not provide real added value.

Although the decisions on the single supervisory system were far more concrete than those taken at the June Summit, there are still more questions than answers on a number of key issues which remain major bones of contention between EU governments:

- Timing:* It is still unclear when the new supervisor will start to operate. The German government – supported by Finland, the Netherlands and the ECB – is standing firm in insisting that the quality of the new supervision system must take priority over the timeframe. Other euro countries – especially France, Spain and Italy – and the European Commission (supported by the International Monetary Fund (IMF)) remain eager to speed up the process, arguing that slow implementation of the new system might undermine the credibility gained with investors in recent months. Some EU officials and national diplomats pressing for a rapid deal and swift implementation have claimed that Berlin is trying to draw out the process – a claim Chancellor Merkel and other German government officials have strenuously denied. In any case, the new supervision system, which will involve setting up a structure within the ECB including around 200-300 people, is unlikely to be put in place before the second half of 2013, although Paris and others – including the Commission – still hope that the process can be completed sooner. Indeed, the Commission's original proposal had foreseen that recapitalisation via the ESM would be possible from the start of 2013. This timetable is now off the table, with ECB President Mario Draghi telling EU leaders at the Summit that it would take 6-12 months to set up the SSM.
- Coverage:* It is still unclear which banks will be directly or indirectly supervised by the new system. Some governments are eager to limit it to a few large, systemically relevant European banks, with Berlin particularly wary about extending direct European supervision to its regional savings banks. Others – led by France, Spain and Italy – want to expand its scope to cover a much larger number of Europe's 6,000 banks. At the Summit, EU leaders agreed that the ECB should "be able, in a differentiated way, to carry out direct supervision". The details of this provision will now have to be worked out by EU finance ministers and the ECB. In the end, 'differentiated supervision' might entail phased-in direct supervision of (systemically relevant) banks through the ECB and day-to-day supervision of other smaller financial institutions through national supervisory authorities in close cooperation with the ECB, which would be able to intervene in any bank at any time.
- 'Legacy risks':* Another major bone of contention relates to the German, Finnish and Dutch governments' reluctance to allow the new supervisory system to deal with any 'legacy risks', i.e. with banks already in trouble before the European supervisor was established. In other words, the new SSM should only cover 'healthy banks'; financial institutions which have failed a stress test would have to be 'healed' before they are covered by the new system.
- Direct bank recapitalisation through ESM:* The most contested issue relates to the details of a direct recapitalisation of banks through the European Stability Mechanism, to be clarified by EU finance ministers before the December Summit. The European Council reiterated the basic objective of the June deal, stating that it is "imperative to break the vicious circle between banks and sovereigns". But key issues related to the timeframe and which banks might be recapitalised through the ESM remain unclear. With respect to the timeframe, Germany – supported by Finland and the Netherlands – argues that direct support from the ESM should only be possible after the supervisor has been established and its effectiveness has been determined. The Summit Conclusions reflect this position by stating that direct recapitalisation will be possible "once an effective single supervision mechanism is established", but it is by no means clear what "effective" will mean in practice and who (the ECB?) will determine whether and when the new system has reached an adequate level of operational capacity. Another issue which needs to be clarified is which banks and which assets would be eligible for direct recapitalisation. Two specific questions remain: first, would the ESM only be able to recapitalise (systemically relevant) banks directly supervised by the ECB or also banks covered (mainly) by national supervisors? Second, would direct recapitalisation exclude 'legacy assets'; i.e. would the ESM be barred from directly supporting financial institutions which got into trouble before the new system was put in place? At her post-Summit press conference, Chancellor Merkel declared there would be no "retroactive direct recapitalisation". Should this be the case, the Spanish, Irish and/or Greek banks that are already in trouble would not be able to ask for direct assistance from the ESM, and the 'vicious circle' would thus not be broken, undermining to a large extent the original objective set at the June Summit and reiterated in October.

- *Participation of non-euro countries (pre-ins):* There are fundamental issues regarding the terms that will be offered to non-euro countries that want to join the new supervision mechanism. They are worried that the creation of a banking union might negatively effect their banking sectors, which are closely linked to or even owned by eurozone based financial institutions (around 65% of the banking sector in Central and Eastern Europe is in the hands of predominantly Austrian, German, French and Italian banks). The European Council Conclusions state that the new supervision system should be “inclusive and transparent” and that “all Member States are free and invited to join”. However, the devil lies in the detail and it will by no means be easy to agree the specifics of an arrangement aimed at integrating non-euro countries as much as possible. The ‘pre-ins’/outs’ – including notably Sweden, the United Kingdom and the Czech Republic – are particularly worried that they might be marginalised in the process. The Summit Conclusions therefore state that it is “important to ensure a level-playing field between those Member States which take part in the SSM and those which do not” and that the “integrity of the Single Market in financial services” will have to be fully respected. The most contentious and difficult issues relate to the future role of the European Banking Authority (EBA) and how to organise non-euro countries’ participation in an ECB-based banking supervisory system in line with the EU Treaties.
- *Other open issues:* There are a number of other issues related to the creation of a single supervision system and wider questions about the creation of a banking union which still need to be settled. Every one of these points could delay the process. First, the European Central Bank and member-state governments have to find a practical and legal way to ensure that the ECB’s monetary functions are kept independent from its new banking supervisory role. Second, some member states – including Germany – might argue that those countries with a bigger banking sector should have a greater say on the board of the new supervision mechanism, thus abandoning the one-country-one-vote principle by introducing different voting weights. Third, the problems related to the creation of the SSM have offered just a taste of the political, legal and technical challenges that will have to be overcome when it comes to setting up the two other key components of a banking union (banking resolution and deposit guarantees). The European Council Conclusions ‘merely’ call for the rapid adoption of provisions relating to the “harmonisation of national resolution and deposit guarantee frameworks” based on the Commission’s legislative proposals, and note the latter’s intention to propose a single resolution mechanism for member states participating in the SSM.

II. Integrated budgetary framework – fiscal capacity, ‘super commissioner’ and ‘anathema’

With respect to the creation of an integrated budgetary framework, three elements are worth analysing: (1) the establishment of a “fiscal capacity” (‘euro budget’/‘solidarity fund’); (2) the idea of creating a ‘Super Commissioner’; and (3) the prospects for a partial collateralisation of debt.

(1) Fiscal capacity – the new kid on the block

One issue discussed intensely in the run-up to and at the Summit was the idea of creating some form of separate ‘eurozone budget’ or ‘solidarity fund’. Following on from the June 2012 Van Rompuy report and the latest interim report, the Summit Conclusions state that an “appropriate fiscal capacity” for the euro area will be explored in more detail ahead of the December European Council.

This idea has gained momentum and many euro countries have signalled support for (or at least initial interest in) it. But there is still little clarity about its basic objective, functions, financing, size, scope and timing. The idea attracted so much attention that President Van Rompuy decided to provide a “background note” to national delegations just before the Summit. But many key issues still remain open:

- **What would the purpose of the budget/fund be and who would profit from it?** There are different views on this: Paris perceives it as a permanent budget used to support member states in certain fields such as (youth) unemployment. Berlin, on the other hand, thinks of it as a ‘solidarity fund’ which would be used to support projects aimed at increasing, for example, the competitiveness of certain member states. President Van Rompuy foresees two

potential functions: it could either be used as an instrument to absorb “country-specific economic shocks” by setting up “an insurance-type mechanism” or it could “support structural reforms”. In any case, the fiscal capacity could be a useful instrument to incentivise and support structural and public finance reforms, especially in the crisis countries or member states subject to an Excessive Imbalance Procedure. The interim report states that a new fiscal capacity could “facilitate structural reforms that improve competitiveness and potential growth” through “limited temporary, flexible and targeted financial incentives”. The eurozone budget could thus be used as a carrot; i.e. as financial support to help countries to carry out reforms made conditional on fulfilling a country-specific reform contract elaborated in the framework of the European Semester. Support for countries and citizens hit hardest by the crisis to alleviate its social impact would, of course, also be in the self-interest of the better-off member states. Part of the intention must be to show that ‘Europe cares’, thus helping to create constituencies for further reforms and support for the austerity programmes. But this could also backfire – to achieve such an effect, the scale and way of spending must be designed so that the money has a real impact on the ground. If it looks like tokenism, there will be a political backlash.

- **How big would the fiscal capacity be?** To answer this question, one needs to clarify the underlying purpose of a separate eurozone budget. Would it be a (i) a macro-economic stabilisation tool (which many have argued is essential for a currency union); (ii) a federal-style equalisation/transfer mechanism; or (iii) a way to deliver targeted but limited funds to either alleviate the social impact of the crisis or to promote projects aimed at strengthening, for example, the competitiveness of a member state. Both macro-economic stabilisation and a general transfer mechanism seem rather unlikely given that key member states are fiercely opposed to any form of transfer (the interim report states that the fiscal capacity would “not lead to permanent transfers”) and that such mechanisms would have to be much bigger than the €20-30 billion *per annum* mentioned occasionally in the current debate.
- **How could the budget/fund be financed?** The fiscal capacity could be financed either through national contributions from participating member states and/or through the new Financial Transaction Tax (more member states might be persuaded to join enhanced cooperation on the FTT if support from the fiscal capacity were linked to the introduction of the new tax). President Van Rompuy has proposed that the fiscal capacity could function as an “insurance-type mechanism” to which every member state would “over time contribute” and “then benefit from its support” in bad times when “countercyclical fiscal policy” is required. In any case, the bulk of this budget would have to come from the strongest euro countries, which raises the question of what is in it for Germany (and other lender countries) aside from showing ‘solidarity’. One possible explanation is that it is a concession intended to counter opposition from the current German coalition government to the collateralisation of debt, in essence showing that help is available but wide-scale Eurobonds or any other form of substantial debt mutualisation are not on the table. It thus comes as no surprise that Berlin was particularly annoyed about the reference in the interim report to the possibility that a future fiscal capacity might have the “ability to borrow”.
- **How would the fiscal capacity relate to the ordinary EU budget and to non-euro countries?** Given that this budget/fund would aim to alleviate eurozone difficulties, it seems clear that it would not be part of the Multiannual Financial Framework. But it would nevertheless affect countries outside the euro zone. The pre-ins, who are legally obliged to join the euro eventually, are already concerned about the implications of a separate budget, not only in terms of their political participation and the potential impact on the MFF (would there be less cohesion funding?), but also of even more ‘help’ being available to current euro-zone members, thus potentially undermining a level-playing field in the EU-27. Reflecting these concerns, the Summit Conclusions explicitly state that the “process of exploration” regarding the setting up of a fiscal capacity will be “unrelated to the preparation of the next Multiannual Financial Framework” (but what about subsequent MFFs?). President Van Rompuy underlined that the new fiscal capacity would not “increase the split between eurozone members and others”, arguing that it would be set up within the EU structures. In any case, if a eurozone budget/fund aims to be inclusive, then a mechanism must be found to include the pre-ins in the process if they wish to participate.

- **When and how would the budget/fund be put in place?** There is no clear indication on this. The interim report merely mentions the need to explore this option “in the longer term”. Given the lack of detail about the basic characteristics of a ‘euro budget/solidarity fund’, it is difficult to predict whether this would, in the end, require treaty change (which would certainly postpone its introduction) or whether it could be set up within the existing legal framework. The interim report merely states that “ways to develop this capacity within the framework of the EU and institutions” will be examined. Concerning a potential timeframe, Chancellor Merkel was more explicit and rather ambitious at her post-Summit press conference, saying that the new fiscal capacity should be set up as quickly as the new banking supervision system.

(2) Stronger economic governance – a new ‘Super Commissioner’?

Another prominent issue popped up in the week of the Summit following a proposal from German Finance Minister Wolfgang Schäuble to allow the Commissioner for Monetary Affairs to veto the budgets of member states subject to an excessive deficit procedure if their proposals do not comply with agreed deficit targets, and as a result to require national parliaments to revise their budget plans (increasing revenues or reducing expenditure would, however – according to Mr Schäuble – remain a national prerogative).

Mr Schäuble’s proposal for a ‘Super Commissioner’, publicly endorsed by Chancellor Merkel in a speech to the Bundestag just before the European Council, prompted lukewarm or even negative reactions in Germany, in other EU member states and in Brussels. Strong opposition was voiced by the German Liberals (FDP), the coalition partner of Mr Schäuble’s CDU, and by key representatives of the CDU’s sister party, the Bavarian CSU, particularly complaints about a substantial loss of national budgetary autonomy. President Hollande also voiced strong criticism, signalling his frustration with Germany’s emphasis on longer-term structural issues rather than the questions which had to be decided at the October Summit.

In Brussels, EU officials argued that the German finance minister’s proposal was not new, did not go substantially beyond the proposal included in the so-called ‘two-pack’, and had already been raised in the interim report. Some even speculated that Mr Schäuble’s main aim was to shift attention away from other issues on the agenda (especially banking supervision). The Commission’s November 2011 proposal for a regulation (one element of the two-pack) foresees that euro-area countries shall submit their draft budgetary plan for the following year to the Commission and Eurogroup. If the Commission considers that it shows serious non-compliance with the Stability and Growth Pact, it can require a revised plan. This already goes substantially beyond the Commission’s current powers, but the German finance minister’s proposal goes one step further, as it gives the ‘Super Commissioner’ the right to veto a national budget – an innovation which would require a Treaty amendment. It is also more explicit than the interim report, which ‘merely’ calls for a “greater degree of common decision-making on budgets, building on the provisions in the ‘Two-Pack’ regarding the examination of draft budgetary plans”.

The proposal raises a number of questions that need to be addressed in the context of a further deepening of fiscal integration: will member-state governments and parliaments be willing to surrender substantial sovereignty rights over their national budgets well beyond the limits foreseen in the two-pack? And if so, under what conditions and in return for what other concessions? Will Paris and even Berlin be ready to accept such a loss of budgetary autonomy? If so, would this in the latter case not require an amendment of the German *Grundgesetz* through a referendum? Is this maybe one reason why Mr Schäuble also asked for the EU Treaties to be revised via a European Convention, to provide the grounds for a future change to the German constitution? Or was the proposal nothing more than an attempt to distract attention? Assuming that Germany would be ready and willing to press ahead with this, would Berlin in return be ready to accept some form of partial debt collateralisation as demanded by the French? These and other questions will have to be addressed and eventually answered in the weeks, months and years to come.

(3) Debt collateralisation – anathema, but forever?

As expected, the European Council Conclusions do not refer directly or indirectly to any form of debt collateralisation, even though the interim report very cautiously indicates the possibility of some form of joint liability. Berlin was angered that the

report (once again) mentioned the need to collateralise debt rather than to find (additional) ways and mechanisms to further tighten fiscal control. In her pre-Summit speech to the Bundestag, Chancellor Merkel reiterated that joint liability for sovereign debt is an “economic meander” which would set the wrong incentives.

Berlin’s criticism seems exaggerated. The interim report presents a balanced approach which takes into account both the German government’s opposition to common debt issuance and the fact that an overwhelming majority of euro countries favour some form of joint liability.

In very careful and sometimes cryptic language, the report states that the establishment of “a genuine euro-area safe and liquid asset could contribute to limiting the negative feedback loops between banks and public finances”. In more concrete terms, it mentions three options. First, it says “the pooling of some short-term sovereign funding instruments (e.g. treasury bills) on a limited and conditional basis” should be examined. Second, it mentions a proposal “to deal with the existing stock of sovereign debt on a conditional and temporary basis through the gradual roll-over into a redemption fund”. Concerning the latter, the report limits the extent of potential mutualisation by stating that it would be limited to the “debt that has been accumulated by most Member States in the run-up to and during the financial and debt crisis” (i.e. since 2008). Third, it mentions the possibility that a future fiscal capacity might have the “ability to borrow”.

The report tries to take German concerns into account. Following the underlying logic that a greater sharing of risks should be accompanied by a commensurate pooling of decision-making, the report advocates a “fully-fledged integrated budgetary framework”, “greater focus on prevention of budgetary imbalances” and “compliance with fiscal rules and fiscal discipline”. However, Berlin remains critical, arguing that it does not mention or further develop more ambitious proposals such as the idea of a ‘Super Commissioner’ able to veto national budgets.

In more general terms, one needs to ask whether it is justified and wise to continue putting pressure on Berlin to agree to some form of debt mutualisation, given that the German government has repeatedly and strongly objected to any kind of joint liability.

This raises a number of basic questions: will Germany ever be ready to accept some form of limited, partial and/or temporary debt collateralisation? Or will it stick to its firm ‘no’ even though most member states, the European Commission and the European Parliament favour some kind of joint liability? Could a change of government in Germany after the federal elections in September 2013 open up the possibility of crossing certain ‘red lines’, which might require changes not only to the EU Treaties but also to the *Grundgesetz* through a referendum? If so, what might Germany ask for in return: a more binding form of budgetary control ultimately scrutinised by the European Court of Justice, which would go beyond even the Fiscal Compact Treaty? Is there any form of debt mutualisation which might be more acceptable to Berlin? Would a less ambitious model than those proposed thus far be more attractive? Would a form of joint liability be acceptable which ‘limits’ the mutualisation of debt to new government debt issued after explicit and obligatory approval from the Eurogroup? Or is there no way to overcome Berlin’s basic argument that any form of collateralisation would set the wrong incentives and is not possible while national budgets remain in place? Or is there maybe now less need for collateralisation of debt following the introduction of the ECB’s OMT programme, which already aims to keep member states’ refinancing costs at “viable” levels?

The time has come to openly address all these questions to overcome one of the biggest impasses of recent years. The endless debates about collateralisation of debt have absorbed a lot of political energy and hampered progress towards an overall compromise between member states. The need to agree on a roadmap towards a “Genuine EMU” has increased the pressure to find a solution, which would require a compromise between Berlin and Paris – a prospect which, unfortunately, has become less likely given the increasing polarisation between France and Germany in recent months.

III. Integrated economic policy framework – contractual arrangement with ‘carrots’

EU leaders took a number of decisions with respect to the third building block of a ‘Genuine EMU’. Aiming towards an integrated economic policy framework, the European Council invites legislators to find an agreement with a view to adopting

the two-pack by the end of 2012 at the latest. EU leaders also called on national authorities and EU institutions to implement the enhanced model of economic governance (including the reinforced Stability and Growth Pact, the Fiscal Compact Treaty and the 'six-pack'). President Van Rompuy argues that the use of all existing tools will already be a major step towards fiscal and economic union, but that to secure the long-term stability, "we need to be able to better deal with economic shocks, and spur closer economic convergence".

One way to promote closer economic convergence is proposed in the interim report and in the Summit Conclusions: namely, the idea (which is actually not new!) that euro countries should enter into "individual arrangements of a contractual nature" with the EU institutions. This proposal – backed by Berlin and viewed rather critically in Paris – aims to promote the implementation of structural reforms identified in the country-specific recommendations issued in the framework of the European Semester. To increase democratic legitimacy, these 'contracts' between individual member states and the EU could be ratified by national parliaments.

The key innovation is the idea of financially supporting member states in their efforts to carry out reforms. Unlike in the past, this approach does not rely simply on peer pressure or on fines and sanctions; it is based on concrete incentives which could not only promote the implementation of country-specific recommendations, but also increase political ownership of national reform programmes agreed at European level, which up till now have often ended up in the drawers of national public administrations.

In more concrete terms, financial support could be provided through the new fiscal capacity, which could be used to either (i) financially cushion the negative effects of certain structural reforms, including for example an increase of (youth) unemployment (the French proposal), or (ii) finance specific projects aimed at increasing the competitiveness of the country concerned (the German proposal). More in line with the latter option, President Van Rompuy has suggested that the contractual arrangements could be supported by the euro-area fiscal capacity "on a case-by-case basis" for "growth-inducing reforms that are particularly costly" or that are "difficult to carry out because of economic circumstances".

In any case, this is a promising idea which needs to be further explored ahead of the December European Council. Among the many questions which will have to be addressed are the following: (1) Who would conclude the contractual arrangement between member states and the EU – the European Commission? (2) Will – and, if so, how – (would) the European Parliament be involved in the process? (3) Would non-euro countries concluding contractual arrangements also enjoy support from the new fiscal capacity? (4) Who would take decisions about the disbursement of financial assistance and who would be responsible for managing the funds (the Commission)? (5) How much money would be required and where would it come from?

IV. Democratic legitimacy and accountability – need for a public debate

The fourth building block, which aims to enhance democratic legitimacy and accountability, is once again the weakest of the four elements on the path to 'Genuine Economic and Monetary Union'.

The Summit Conclusions simply include the rather empty and unspecific phrase that "strong mechanisms for democratic legitimacy and accountability are necessary". Following the basic line of the interim report, the Conclusions state that the guiding principle is "to ensure that democratic control and accountability take place at the level at which decisions are taken and implemented". The only concrete idea mentioned is that "ways to ensure a debate in the context of the European Semester", both within the European Parliament and national parliaments, should be explored.

Neither the June report, nor the September issue paper or the interim report – which could have at least tried to streamline and maybe even stimulate the debate – listed or evaluated any of the new and old proposals that have been put forward over the last couple of months, including *inter alia*: directly electing the Commission President; a stronger link between the outcome of the 2014 European elections and the (s)election of the next Commission President; introducing a 'big double hat' combining the posts of European Council and European Commission President; substantially reducing the size of the Commission; (partially) selecting Commissioners from the ranks of the European Parliament; extending the powers of the

European Parliament in the framework of deepening economic and fiscal integration (e.g. supervision of excessive deficits); providing the Parliament with a right of initiative; flexible configurations of the Parliament; more proportional representation of member states in the Parliament; establishing a special body composed of national (and European) parliamentarians; involving national parliaments in economic and budgetary supervision; appearances by national ministers in the Parliament to explain structural reforms under way in their countries; hearings of EU Commissioners in national parliaments.

None of these or other proposals are being put on the table openly in the framework of the current process aimed at deepening EMU integration. There are probably three key reasons for this. First, proposals aiming to enhance democratic legitimacy and accountability cannot be discussed before there is more clarity about the concrete measures/innovations that will be introduced in the three other building blocks. Second, President Van Rompuy and the three other presidents do not want to enter into a tricky debate about the EU's future institutional architecture, as this might upset many of the member states and institutions involved in the process. Third, any debate about a reform of the Union's institutional structure would further spur the discussion as to whether the EU Treaties will have to be amended to achieve some of the potential institutional reforms.

However, there is a need for a thorough and also to some extent public debate about potential reforms to enhance the Union's democratic legitimacy and accountability. At the end of the day, these issues will have to be tackled. The question is whether this can be done within the current procedural framework behind closed doors or whether it will require other *fora* enabling and provoking a constructive debate about key aspects of democratic legitimacy and accountability. In this context, the December European Council could, for example, decide to set up something like a 'wise (wo)men group' or a 'reflection group', which could come up with concrete proposals in 2013 on how to strengthen the EU's legitimacy and accountability.

Timetable and next steps

Informal consultations will continue over the next two months among member states and the European Parliament. At the 13-14 December EU Summit, the European Council, Commission, Eurogroup and ECB presidents are expected to present a roadmap laying down the process and concrete steps towards a genuine EMU, which will then have to be endorsed by the heads of state and government. Commission President José Manuel Barroso has already announced that the Commission will present its own blueprint for EMU in a few weeks, as a contribution to the debate, and it will be interesting to see the ways in which these ideas will differ from the proposals mentioned in the Van Rompuy documents (treaty changes?).

Many issues remain open, not only with respect to concrete elements of an 'EMU 2.0', but also regarding the post-December reform process. The Van Rompuy reports have not indicated, let alone specified, how and in what stages the roadmap presented in December will be implemented. Nor is it clear whether some of the innovations required to move towards a genuine Economic and Monetary Union will require some form of (limited) treaty change or maybe even additional intergovernmental treaties. Bearing in mind the negative experience with the rejection of the Constitutional Treaty in 2005, most member-state governments and key EU actors – including President Van Rompuy – seem (very) keen to avoid a discussion about any kind of (major) treaty change at this stage. However, some innovations aimed at deepening economic and fiscal integration might eventually require changes to the EU's primary law. If so, it might be wise to start thinking about the 'how' and 'when' of future reform.

Compact for Growth and Jobs – waiting for an 'age of economic enlightenment'

On Day Two of the Summit, EU leaders reviewed progress on measures related to the Compact for Growth and Jobs, agreed at the last EU Summit in June. This is not a legal document like the "Treaty on Stability, Coordination and Governance" (also known as the Fiscal Compact Treaty or Stability Treaty), but rather a political declaration by the 27 heads of state and government which aims to re-energise Europe's stalled economy. It is primarily a politically-motivated document, designed to demonstrate that the EU institutions and member states are ready and willing to follow a more balanced crisis approach between austerity and growth. The Compact is particularly significant for President Hollande, who

had fought strongly for it during his presidential campaign and wants to signal to citizens that the EU is not indifferent to growth and (youth) unemployment.

In principle, the goal of the Compact, which *inter alia* aims to inject €120 billion into the economy (€60 billion lending capacity; €4.5 billion for Project Bonds; €55 billion via reallocated Structural Funds) to promote growth and jobs, points in the right direction. However, its impact to date has been rather limited. Following a Commission stocktaking exercise, President Barroso has publicly criticized Member States for failing to implement growth measures to balance the negative impact of harsh austerity policies. Just before the EU Summit, he said bluntly that he was “not happy with the progress made so far”[...]“unfortunately, we see little willingness on some of our governments to ensure appropriate funding for key instruments to help offset the negative social impact of the crisis”. The Compact has not been sufficiently implemented in areas such as savings tax, energy taxation, public procurement reform and venture capital, and progress on legislation to complete the Single Market has been rather slow.

This lack of ambition and concreteness is also reflected in the European Council Conclusions, which include a long list of issues, most of which were already mentioned in the March and June 2012 Summit Conclusions. The **11 areas and specific measures** listed are: (1) investing in growth (implementation of €120 billion financing package of the Compact); (2) deepening the Single Market (more efforts to complete the Single Market Act I and the adoption of Single Market Act II proposals by June 2014); (3) the Connecting Europe Facility (instrument to promote growth through investment in transport, energy and ICT links); (4) achieving a fully functioning Digital Single Market by 2015; (5) promoting research and innovation (call for rapid progress on ‘Horizon 2020’ and ‘COSME’); (6) enhancing the competitiveness of industry; (7) creating the right regulatory framework for growth (reducing the regulatory burden at EU and national levels); (8) developing a tax policy for growth (energy taxation; common consolidated tax base; revision of savings tax; enhanced cooperation on Financial Transactions Tax); (9) boosting employment and social inclusion (Employment Package; cross-border pension rights; Posted Workers Directive; youth employment; labour mobility; EURES reactivation of older workers); (10) implementing the Europe 2020 strategy (improvement of European Semester process; early submission of Commission’s Annual Growth Survey and Alert Mechanism Report); and (11) harnessing the potential of trade (Free Trade Agreements with Japan, Canada, Singapore; comprehensive transatlantic trade and investment agreement; Deep and Comprehensive FTAs with neighbouring countries).

Beyond the fact that it is unclear whether, how and when the long and ambitious list of areas and measures mentioned in the Summit Conclusions will be implemented, there is a more concrete reason to be critical: the catalogue of measures aimed at promoting jobs and growth fails to emphasize the need to promote economic development particularly in the countries hit hardest by the crisis. Growing economic divergence within the EU, especially within the euro zone, was one of the key factors that led to and fostered the crisis, and the latest economic forecasts suggest that this gap is likely to widen.

It is thus necessary and would be wise to improve the economic outlook, especially in Europe’s ‘periphery’. The euro area will not be able to bear the political, financial, social and political costs of a ever-widening divide between an economically strong centre and a weak periphery, which is one factor undermining overall confidence in the future of the euro. Balancing national budgets and implementing structural reforms remains an undisputed necessity, but the policy mix required to fight the causes and effects of the crisis need to be further reconsidered. In this respect, the new ‘contractual arrangements’ financially supported by the new ‘fiscal capacity’ (provided that the latter is big enough) could be a promising instrument.

The debate in the EU between those who have strongly argued for a robust focus on fiscal consolidation and discipline, and others who insist that austerity measures alone will not suffice to prevent or counter recession, was prominently fuelled in the week(s) ahead of the Summit. Following a new assessment in the IMF’s World Economic Outlook about the threats of hasty fiscal consolidation, the Fund’s Managing Director Christine Lagarde publicly called on eurozone countries not to stick blindly to tough deficit targets if growth weakens more than expected. She argued that: “It is sometimes better to have more time.” Some European politicians reacted with irritation to the IMF’s shifting stance, fearing that it might undermine the pro-austerity consensus in the EU. It remains to be seen whether, and when, the discussion will also shift within the EU. In the words of Wolfgang Münchau: “An age of economic enlightenment will arrive eventually, but not quite yet.” (*Financial Times*, 14 October 2012).

Danger number one: complacency

The October European Council was a stepping stone, an intermediate Summit on the way to a decisive meeting of EU leaders in December, when key decisions with respect to the Union's long-term future will have to be taken. Almost three years after the outbreak of the eurozone crisis, the prospects for the future of the common currency look much more promising today than they did before the summer, when the Union had found itself in 'deep crisis mode'. The ECB's decision to provide the 'big bazooka', the EU's readiness to address the incomplete construction of Economic and Monetary Union, and the substantially reduced risk of a 'Grexit' have – at least for the time being – reduced the danger of a systemic meltdown.

However, there is no room to lie back and relax. Despite the promising signs, the crisis is by no means over and the situation remains fragile both at European and national level. There are numerous uncertainties and dangers that could once again undermine confidence and threaten the current relative calm. Some of the biggest issues were not even (thoroughly) addressed by the Summit. After months of uncertainty, the 'Spanish question' has not yet been resolved, and the country is moving deeper and deeper into recession. However, Spanish spreads have fallen and opposition to a request for a precautionary credit line from the ESM seems to have faded in recent weeks both in Madrid and other euro-area capitals, which might pave the way for the ECB to activate its OMT programme if need be. But socio-economic tensions are rising and the extreme levels of private debt (well over 200 per cent of GDP) increase the risks for Spanish banks, which might prove to be higher than originally thought.

The Greek crisis still looms, although the chances of the country remaining in the euro zone look much brighter than earlier this year, which is good news for both Greece and with respect to the crisis in general. Although the issue was not on the Summit agenda, euro-area heads of state and government decided to issue a separate statement welcoming the "determination of the Greek government to deliver on its commitments". The political mood towards Greece has improved substantially since July and it seems almost certain that Athens will conclude a final agreement with the Troika, which will allow for the (conditional) disbursement of the next tranche of assistance in November. However, despite the many promising signs, there is no automaticity about recovery. The continuing contraction of the Greek economy, the extremely high levels of (youth) unemployment, the worrying rise of political extremism, and the high levels of Greek debt remain heavy burdens on the way towards a more promising future.

Other countries, including Cyprus and Slovenia, might have to join the group of 'programme' countries, reducing further the number of lender countries and maybe (further) increasing public opposition in Germany, Finland and the Netherlands to the crisis recipe, especially if the overall growth perspectives for Europe are threatened by a downturn in the global economy.

In more fundamental terms, the EU and its members are having to increasingly cope with the collateral damage caused by the crisis: an increasing national focus and anti-euro/EU populism, mounting socio-economic challenges and increasing frustration among the young population in more and more member states; a growing 'democracy deficit' at national and European level; a poisoned atmosphere among member states and even between national societies; growing separatist tendencies in more and more EU countries – to name some of the unintended and unexpected consequences of the crisis at both the European and national level which could challenge past accomplishments of and future prospects for European integration and an exit from the crisis.

But the biggest danger today is that of complacency. As the crisis has moved from a very hot phase before the summer to a less intense period ahead of the October Summit, there is a danger that governments might run out of steam in the weeks, months and years to come. Collective fatigue and complacency could undermine the necessary efforts to continue strengthening the more immediate crisis shields and to further deepen *sui generis* fiscal, economic and (ultimately) political integration.

Since 2010, 'muddling through' has been the EU's dominant mantra and this is not likely to change in future. Yet the crisis has put continuous pressure on member-state governments and the EU institutions to go beyond the lowest common

denominator – not because of a particular credo or vision, but out of necessity and fear of the severe consequences should the euro or the EU itself move closer to the ultimate abyss.

As the systemic risk of a euro implosion seems to have declined, there is a danger that ‘muddling through’ might be less ambitious than it needs to be to manage and eventually overcome the crisis. The loss of determination to create a banking union, the inclination to backtrack from decisions taken at the June Summit, an increasingly ‘let’s wait-and-see attitude’, the growing polarisation of France and Germany, and the rise of ‘petit party politics’ are all worrying signs.

Member states and the EU institutions face a major dilemma. On the one hand, the crisis is needed to push governments to do things which seemed impossible only a few years ago; on the other, there is a constant fear that it might get out of control, that the ‘crisis snowball’ might keep on growing and in the end trigger a financial, economic, social and political avalanche big enough to bury the European project beneath it. The EU needs to find a way to commit member states and its own institutions to a high level of ambition without the constant pressure of an escalating crisis. The most effective way to do this would be for EU governments sign up to an ambitious and detailed agenda at the December Summit, with a concrete timetable for the months and years ahead.

This process should not be limited by taboos. There are good reasons to believe that the path towards a genuine EMU, which necessitates a higher level of *sui generis* fiscal, economic and ultimately political integration, will at some stage require (more substantial) reform of the Union’s primary law. Some of the proposals made in recent weeks and months – not only by EU commentators and experts, but also by leading politicians including 11 EU foreign ministers – would definitely require major changes to the EU Treaties. In the week of the Summit, Mr Schäuble called not only for a ‘Super Commissioner’, but also for a European Convention to be set up by the end of this year. However, it is not clear what Berlin will officially ask for, as Chancellor Merkel is still playing her cards close to her chest.

The process towards more ambitious reforms involving treaty change should not start now, but rather after the European elections in June 2014, which should be used as a platform for debate about the future of European integration. Before the Union launches this complex and difficult process, its institutions and member states must construct a strong enough ‘safety net’ to protect the euro and the EU from hitting the ground face first in the months to come. In other words, in the more immediate future (2012-14), the EU needs to do everything possible using the current Treaties, before it embarks on a more ambitious journey towards radical changes to its politico-institutional and legal structures.

This process cannot be confined to governments, but will also have to involve the European Parliament and national parliamentarians in the framework of another convention. The outcome of this convention will then be the subject of an intergovernmental conference and the new treaty will subsequently have to be ratified in all EU countries. A further pooling of economic and fiscal sovereignty will also necessitate changes to national constitutions. Ratification of the Union’s new primary law and changes to national constitutions will inevitably require referenda in a number of countries. The outcome of these referenda will be highly uncertain. But this is a risk that must be taken at some point: the danger of a euro implosion or a potential exit from the common currency, combined with a strong narrative explaining why changing the EU Treaties is unavoidable, may prove to be strong arguments to persuade a majority of Europeans to vote ‘yes’.

Opening up the path towards yet another major reform involving treaty change is no easy choice, but it is probably the only way to keep Europe moving forward. And setting the bar high enough is probably the best way to overcome the danger of complacency and to do what is needed to ultimately overcome the crisis.

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