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Post-Summit Analysis

The perils of complacency – the results of an unspectacular summit

Summary

The 1-2 March European Council was an unspectacular summit during which EU leaders did their best to demonstrate that the European Union is slowly but surely moving out of the euro debt crisis. This analysis by Janis A. Emmanouilidis, however, warns that the situation remains fragile and that the political dangers and longer-term effects of the crisis will haunt the EU and its members for some time – even though the crisis seems to be moving into a less critical phase due to the massive intervention of the European Central Bank.

Full report

Contrary to most ordinary and extraordinary EU summits over the last two years, the European Council on 1-2 March 2012 was a rather unspectacular, drama-free meeting that was not dominated by immediate concerns related to the euro debt crisis. EU leaders were eager to send a signal to Europe and the rest of the world, to citizens and to markets that the European Union (EU) is moving from 'crisis mode' into 'normal mode'. However, it would be premature and hazardous to sit back and relax while the immediate and longer-term perils and structural reasons behind the euro debt crisis continue to negatively impact upon the EU and its members.

The main issue that EU leaders dealt with during the 2012 Spring European Council was how to stimulate economic growth and create jobs in times of austerity when Europe's economy is moving into a (mild) recession. In the end, the EU 27 agreed on a long list of economic measures to be taken at both national and European level. The renewed emphasis on 'growth and jobs' should be welcomed, but only time will tell whether words will be followed by concrete deeds and whether the new enhanced system of European economic governance will function effectively.

Other issues on the agenda included the granting of candidate status to Serbia, the perspective enlargement of the Schengen area to Bulgaria and Romania, the re-election of Herman Van Rompuy as president of the European Council and his appointment as president of the Euro Summit, and numerous global and foreign policy issues including *inter alia* preparations for a number of international summits (G8, G20, Rio+20), the Union's reaction to the escalation of violence in Syria, and the EU's relationship with its Southern Neighbourhood.

With respect to more immediate concerns related to the sovereign debt crisis, EU leaders – with the exception of the UK and the Czech Republic – signed a new intergovernmental treaty featuring the fiscal compact, and the 17 heads of state or government of the euro zone gave the 'green light' in principle to a second Greek rescue programme, worth around €130 billion until 2014. Due to opposition from the German government, eurozone leaders failed to decide whether to increase the combined firepower of European rescue funds beyond the €500 billion of the permanent European Stability Mechanism (ESM) – but a compromise will most likely be reached in the upcoming weeks.

The fact that the EU Summit did not focus predominantly on the euro debt crisis is an(other) indication that the crisis seems to be moving from a 'hot' to a 'cold(er) phase'. The bold market interventions of the European Central Bank (ECB), which has been offering massive three-year loans in the framework of the so-called 'longer-term financing operation' (LTRO) since the end of 2011, allowed banks to borrow €489 billion in December 2011 and €529.5 billion in February 2012. This has cushioned the liquidity squeeze and calmed down bond markets. Banks have used cheap ECB loans (at a 1 per cent interest rate) to buy sovereign bonds, leading to a substantial reduction of borrowing costs in Italy and Spain.

Even though the crisis has cooled down since late 2011, it has by no means been overcome. ECB interventions and the appreciation of market players that central bankers in Frankfurt are ready to extend their crisis responses even further – if need be – have increased market confidence. However, at the end of the day, the ECB is only able to buy Europe time. It is no substitute for further efforts to counter the immediate and more fundamental causes of the sovereign debt crisis at both European and national level.

The crisis situation remains fragile for a number of reasons:

First, different forecasts (OECD, IMF, European Commission) predict an economic downturn, particularly in Europe's periphery, which has the potential both to further increase economic divergence within the euro area and to undermine the ability and readiness of eurozone countries to do what is required at European and national level to manage and eventually fully overcome the crisis – 'solidarity' between governments is already close to being exhausted.

Second, the economic, political and social situation in Greece remains under strain and overall uncertainty regarding the country's future in the euro zone makes it difficult to break the negative cycle of pessimism, undermines efforts to fundamentally reform the country and casts doubt as to whether Greece will in the foreseeable future be able to push the economic 'restart button' under the conditions of the current crisis recipe.

Third, it remains uncertain whether other 'problem countries' – including programme countries (Ireland and Portugal) and other member states strongly affected by the crisis (like Italy and Spain) – will be able to continue to slash public expenditure, push through structural reforms and increase their economic competitiveness in order to trigger growth and to return to and stay on a sustainable path of fiscal virtue.

And, fourth, EU institutions and eurozone countries still have to provide clear and convincing evidence of the effectiveness of the new system of enhanced economic governance (including a strengthened Stability and Growth Pact (SGP III), the European Semester, the Euro Plus Pact, a system of macroeconomic surveillance, and the fiscal compact). There is a risk that deteriorating public finances in some key euro countries – e.g. in Spain, where the government has just announced an increase in its deficit target for 2012 from 4.4 to 5.8 per cent, or in the Netherlands, where the deficit is expected to soar beyond the 3 per cent target to 4.5 per cent in 2012 – could lead to a softening of budgetary objectives, signalling to markets that Europe is (again) failing to stick to its fiscal rules.

Beyond these more immediate concerns, it is also important to bear in mind three more fundamental political dangers and challenges:

- *Collective fatigue and complacency:* If the crisis moves from a 'hot' to a 'cold' phase in the weeks and months to come, there is a danger that governments might run out of steam, failing to further eliminate the profound structural shortcomings that triggered and/or fostered the crisis, especially with respect to fundamental flaws in the construction of Economic and Monetary Union. Collective fatigue and complacency could undermine necessary efforts to strengthen the crisis shields and to further deepen fiscal and economic integration.

- *Collateral damage:* Unintended and unexpected economic, political and/or social consequences of the crisis at both national and European level could not only jeopardise the EU's ability to master the crisis, but also undermine the Union's capacity to address other current and future challenges within and outside Europe. The rise of Eurosceptic populism and nationalism (the first messengers of a profound crisis of democracy at national and European level) and negative spill-over effects of the euro crisis in other policy areas (including for instance Schengen or foreign policy) – all this collateral damage of the crisis will have profound and long-term effects in member states and the EU alike.

- *Danger of political confrontation:* The euro debt crisis and reactions to it have led to growing distrust and divisions between national capitals and national societies, which could lead to ever more severe political ruptures between EU member states. Old stereotypes and highly inappropriate historical references have reappeared. Mutual recriminations about a lack of solidarity are spreading the seeds of a new European divide, especially as public frustration and anger over the crisis recipe is spreading in both weaker and stronger EU countries. All this creates a dangerous and explosive mixture, which could lead not only to (increasing) social unrest and political turbulence in individual member states, but also to growing tensions within the Union and between national capitals. Fears that the crisis could deteriorate further have in the last two years inhibited or at least suppressed political standoffs. But a cooling of the crisis might 'free' governments and increase the risk of 'political vengeance' fuelled by simplistic populist rhetoric against the EU or against individual member states.

The continuing fragility of the crisis and the more fundamental political dangers and challenges described above will haunt the EU and its members for a long time, even if the crisis moves into a less critical phase. It is therefore still impossible to predict whether at the end of the day, the Union will again be able to adhere to the 'iron law' of European integration, i.e. that the EU always emerges stronger out of a crisis.

Returning to the more immediate concerns of the March Summit, the following analysis addresses several more concrete issues covered during this European Council meeting, including the renewed focus on growth, the signing of the fiscal treaty, the second Greek bailout programme, the increase of Europe's financial firepower, the granting of candidate status to Serbia, the perspective accession of Bulgaria and Romania to the Schengen area, the re-election of Herman Van Rompuy, and numerous global and foreign policy issues dealt with at the EU Summit.

Attempts to switch from 'crisis' to 'growth' mode

This year's Spring European Council concentrated on a question which has assumed centre-stage in public debate over the last couple of months: namely, how to combine and reconcile attempts to foster economic growth, improve competitiveness and create jobs with the need for fiscal consolidation.

Preoccupied with calming down the immediate crisis, EU Summits over the past two years have primarily concentrated on how to reduce public deficits and ensure fiscal discipline. Discussions between EU leaders at the 2012 Spring European Council, however, focused on measures designed to boost growth, competiveness and (youth) employment.

However, despite this overdue shift of attention, EU leaders were once again eager to underline the necessity to ensure fiscal consolidation, arguing that only financial stability will restore confidence in the euro zone, which in the end is a prerequisite for economic growth and the creation of new jobs.

In this line, a separate paragraph in the Summit Conclusions stresses that all member states need to "respect their commitments according to the rules of the Stability and Growth Pact" and that EU countries under market pressure "should meet agreed budgetary targets and stand ready to pursue further consolidation measures if needed".

The eagerness to present a balanced approach with respect to 'growth and austerity' mirrors a more fundamental debate in the EU between those who have strongly promoted the need for a robust focus on fiscal consolidation and budgetary discipline (represented first and foremost by Germany) and others who argue that austerity measures alone will not be enough to prevent or counter economic recession.

This divide within the EU seems to be widening, as a growing number of member states are (once again) moving into or threatened by recession (including *inter alia* Belgium, Greece, Hungary, Netherlands, Portugal, Slovenia and Spain), while others seem to be withstanding the global economic downturn and performing better in terms of GDP growth (including *inter alia* Austria, Denmark, Estonia, Finland, Germany, Latvia, Lithuania, Luxembourg, Poland, Slovakia and Sweden).

In more concrete terms, the European Council agreed on a number of measures and priorities at both national and European level.

At national level, the Summit Conclusions call on all member states to: (1) review their tax systems to make them more effective and efficient (by removing unjustified exemptions, broadening the tax base, shifting taxes away from labour, improving tax collection, and tackling tax evasion); and (2) to increase efforts to make it easier and more attractive for employers to hire people, to remove barriers to the creation of new jobs, and to implement active labour market policies with a special emphasis on strengthening the participation of young people, women and older workers.

Acknowledging the limits of the current system of economic coordination in the framework of the European Semester, the European Council Conclusions state that member states must present "more precise, operational and measurable commitments in their National Reform Programmes and Stability or Convergence

Programmes". The 17 euro- and the five non-euro countries (Bulgaria, Latvia, Lithuania, Poland and Romania) participating in the Euro Plus Pact are also called upon to include further commitments focused on a "small number of essential, timely and measurable reforms" to achieve the Pact's objectives.

These candid points of criticism and the overall experience of the second European Semester seem to reinforce the two biggest deficits of the new framework of economic coordination: (i) a lack of ownership and ambition on behalf of member states, which tend to present not very innovative but rather vague and unspecific measures in their national programmes; and (ii) the fact that the European Semester (including the Euro Plus Pact) lacks a strong means of 'coercion', as it is based on a loose form of intergovernmental coordination.

However, it still is too early to deliver a final verdict. The potential of the European Semester (and the Euro Plus Pact) should not be disregarded by simply comparing it to previous, rather ineffective instruments such as the Open Method of Coordination in the framework of the Lisbon Strategy, for one key reason: the crisis has underlined how highly interdependent member states are, particularly within the euro area. The painful experience of the sovereign debt crisis has the potential to increase the 'level of ownership and coercion', but this will require eurozone countries – especially those called upon to assist their stumbling partners – to be deeply committed to the new instruments and to support and push the European Commission to produce more revealing assessments and concrete, country-specific recommendations.

In a joint press conference after Day 1 of the Summit, European Commission President José Manuel Barroso stated that he had the impression that "heads of state or government are now considering the European Semester as serious business, not just a formality. (…) Colleagues themselves are asking for tighter deadlines, for more concrete programmes, for more precise calendars". And Council President Herman Van Rompuy added that EU leaders had agreed that the "European Council will follow very closely the implementation of the strategic orientations we set out today". The Summit Conclusions even state that the European Council considers that "enhanced 'peer pressure' can help raise the ownership and responsibility at the level of Heads of State or Government" and invites the Commission to provide "transparent scoreboards" as a basis for appropriate benchmarking.

At EU level, the Summit Conclusions list a number of measures aiming to: (1) complete the Single Market by removing the remaining barriers; (2) complete the Digital Single Market by 2015; (3) reduce administrative and regulatory burdens; (4) remove trade barriers and ensure better market access and investment conditions; (5) reach an agreement on the Energy Efficiency Directive; (6) improve the ability to transform research into new innovation targeted at market demands (by *inter alia* completing the European Research Area by 2014, reaching a final agreement on the patent package, improving the mobility and career prospects of researchers, and creating an effective EU-wide venture capital regime); (7) delivering on commitments to complete the internal energy market by 2014; (8) achieving progress with respect to the Commission's proposals on energy taxation, on the common consolidated corporate tax base, on the financial transaction tax, and on the revision of the Savings Tax Directive; (9) rapidly completing regulatory reform of the financial sector; and (10) restoring investor confidence in the EU banking sector and ensuring that credit flows to the real economy.

Numerous items on the above 'to-do–list' were added to the Conclusions during the Summit, particularly after pressure from 12 EU leaders, including *inter alia* David Cameron, Mark Rutte, Mario Monti, Mariano Rajoy and Donald Tusk, who had listed eight growth-enhancing proposals in a letter sent to President Van Rompuy and President Barroso ahead of the Spring European Council. UK Prime Minister Cameron, who together with Dutch Prime Minister Rutte had initiated the joint letter, complained on the first day of the Summit that the 'letter of the 12' (which had not included Germany and France) had not been sufficiently considered. In his press conference after the Summit, Cameron then underlined that the Conclusions had been "fundamentally re-written" to include measures related to the Single Market in services, tackling regulated professions and completing the internal energy market, as well as deregulation and international trade.

To ensure that the Council of Ministers complies with the guidelines provided by the European Council, EU leaders call on the President of the European Council to promote "regular monitoring" of progress achieved on key Single Market proposals in the various Council formations. This monitoring procedure reflects the fact that sectorial Councils have in the past more than once failed to translate into legislative decisions (implementation gap), which had been taken at the level of heads of state or government. It is worth noting that the assignment to monitor the Council also (further) strengthens the European Council and its president in the overall institutional setting.

Beyond the fact that it is by no means clear whether the long and ambitious list of measures mentioned in the Summit Conclusions will be (swiftly) implemented, there is a more concrete reason to be critical: the list of growth-enhancing measures fails to emphasise the need to promote economic development, particularly in the countries suffering most from the crisis. Growing economic divergence within the EU was one of the key factors that led to and fostered the euro debt crisis, and the latest economic forecasts suggest that these differences are likely to grow. It is thus necessary to improve the economic outlook, particularly in the periphery of Europe. The euro area will not be able to endure the political, financial and socio-economic costs of bridging the gap between a strong centre and a weak periphery, which is in the end also a key factor undermining confidence in the future of the common currency. The balancing of national budgets and the implementation of structural reforms remains an undisputed necessity. But there is also a need to promote a 'New Deal' for the euro, based on investment rather than transfers and linked to strict conditionality.

One promising innovation in this direction relates to the fact that the European Council has decided to step up work on the pilot phase of the Commission's "Europe 2020 project bond initiative" with a view to reaching agreement by June 2012. Project bonds – first proposed by the Commission in September 2010 and not to be confused with 'Eurobonds' or 'Stability Bonds' – could open up new ways to stimulate private (co-)financing of key infrastructure projects.

Limits and perspectives of the new fiscal treaty

With the exception of the UK and the Czech Republic, 25 EU leaders in the morning of the second day of the Summit signed the *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union.*

This intergovernmental treaty, which includes the so-called fiscal compact and was particularly promoted by the German government, has been heavily criticised over the last few months for a number of reasons. Some have questioned the added value of the new treaty, arguing that almost all of its content could have been implemented via secondary EU legislation and did not require a separate intergovernmental treaty outside the Union's legal framework, which has the potential to undermine the EU's institutional coherence. The vast majority of countries that have not (yet) introduced the common currency expressed fears that the fiscal treaty would widen the dividing line between euro and non-euro countries. Others have complained that the introduction of a 'golden rule' into national law along the lines of the German *Schuldenbremse* (debt brake) is economically counter-productive, arguing that excessive public austerity during an economic downturn further deepens economic recession and ultimately also undermines efforts to reconcile public finances.

Criticism *vis-à-vis* the new fiscal treaty seems exaggerated. With respect to the role of EU institutions, one should bear in mind that the European Commission and the European Parliament (EP) were strongly involved in the elaboration of the fiscal treaty and that the new intergovernmental treaty will not lead to the establishment of new institutions outside the EU framework, but rather strengthen existing institutions. The introduction of a higher level of automaticity through the introduction of the reverse majority rule (Article 7) will enhance the Commission's role in the excessive deficit procedure. The Commission is also attributed a key role when it comes to monitoring the compliance of contracting parties: if the Brussels executive holds that a member state has failed to comply with the rules of the fiscal compact, the matter will be brought to the European Court of Justice by one or more of the contracting parties (Article 8). Finally, the scope of the treaty is rather limited, and signatories have also agreed that within five years at most following its entry into force, the necessary steps will be taken to insert the substance of the intergovernmental treaty into the EU's legal framework (Article 16; "repatriation clause").

As regards the involvement of non-euro countries, they participated in the drafting of the new treaty, which is and will remain open to all EU member states. Eight countries that have not (yet) introduced the common currency signed the fiscal compact treaty (Bulgaria, Denmark, Hungary, Latvia, Lithuania, Poland, Romania and Sweden) and after some discussion, a compromise was found in the end on how to include non-euro countries in (at least) some of the Euro Summit meetings.

From an economic perspective, one can actually challenge the validity of the 'golden rule', i.e. that the budget of the general government shall be balanced or in surplus. However, the intergovernmental treaty leaves some room for discretion and interpretation. Most significantly, the treaty states that in "exceptional circumstances" the contracting parties may temporarily deviate from their medium-term objective or the adjustment path towards it. Such "exceptional circumstances" could be related to an unusual event outside the control of a contracting party or to periods of severe economic downturn, provided that the "temporary deviation does not endanger fiscal sustainability in the medium term".

It is too early to provide a final judgement regarding the overall value of the new intergovernmental treaty. Those who have promoted it – first and foremost the German government – have argued that the new treaty (i) will help to secure fiscal discipline in order to overcome the current sovereign debt crisis and to avoid its repetition; (ii) is a significant step towards the establishment of a fiscal or 'stability' union (Stabilitätsunion), as German policymakers prefer to call it; and (iii) that it constitutes a political statement as to the irreversibility of the euro. Only time will tell whether the fiscal treaty can actually carry out these functions.

But the treaty's biggest value is a different one: it provides a strong political argument for Germany and others like the ECB to support and to defend additional efforts to overcome the crisis in the face of increasing political and public opposition. It can already be observed that policymakers are 'using' the fiscal treaty to argue in favour of further measures aimed at countering the deterioration of the crisis (e.g. regarding a second Greek bailout or increasing the financial 'firewall'). It remains to be seen whether it will be equally or even more politically 'useful' in the months and years to come, for example with respect to the (partial and temporary) collateralisation of debt.

The new treaty will enter into force on 1 January 2013 (or earlier), provided that twelve euro countries have ratified it. The fiscal treaty will thus become legally valid even if ratification is unsuccessful in one or another member state. This provision became particularly important after Irish Prime Minister Enda Kenny announced that the attorney-general had recommended that the Irish constitution required the treaty to be put to a public vote.

The decision to hold a referendum, which was announced in the week of the March Summit, came as a surprise, as the content and wording of the treaty had been 'designed' to avoid a referendum. The Irish government and others had been particularly eager to limit the effects of the fiscal treaty on the national sovereignty of contracting parties. However, the attorney-general's recommendation to hold a referendum was prompted by the fact that the treaty was drawn up outside the EU's legal framework – a heavy blow for those (like the German government) who had opposed a change of EU Treaties via the simplified revision procedure.

It is highly unclear whether Irish citizens will vote 'yes' in the referendum. The Irish government holds that when the importance and merits of the treaty are communicated to the Irish people they will "endorse it emphatically by voting yes to continuing economic stability and recovery" (Prime Minister Kenny).

Some believe that the Irish will have little choice but to vote in favour of the treaty, since a 'no' could negatively affect the country's recent positive economic development and would mean that Ireland will not be able to access rescue funds from the ESM, as access to the permanent rescue mechanism requires a country to have ratified the fiscal treaty. Now, one could argue that Ireland is already on a positive economic path and that the country will not require a second European bailout, but this presupposes that the country will be able to return to the markets in 2014, which is by no means certain.

In more general terms, the level of Euroscepticism in Ireland has increased significantly in recent years and one cannot rule out the possibility of an Irish 'no', as they have already said 'no' twice in the past upon being asked to vote on a European treaty (Nice Treaty (2001); Lisbon Treaty (2005)). Opposition parties have announced that they will campaign against the fiscal treaty.

Experience shows that referenda are usually not confined to the actual question at stake – in this case, the ratification of the intergovernmental treaty. The referendum could easily turn into a public vote on the current government or the country's overall situation; and many citizens are very critical of the 2010 'bail out', arguing that it was imposed on them and was mainly designed to rescue trembling banks (in Ireland and beyond), and that it did not cushion the effects of the banking crisis for 'ordinary' people.

An Irish 'no' to the stability treaty would not only affect the country itself, but would also have negative repercussions for the overall debt crisis:

- First, it would provoke speculation as to whether Ireland can remain within the euro zone, which would undermine efforts to regain confidence with respect to the 'historical irreversibility' of the common currency. Irish Finance Minister Michael Noonan had already in December 2011 warned that a public vote on the treaty would effectively be a referendum on euro membership.

- Second, an Irish 'no' to the intergovernmental treaty would raise doubts as to whether the EU and especially the countries of the euro zone are able to further deepen economic, fiscal and political integration – whether national political elites are able and citizens ready to support a stronger role for 'Brussels' regarding national economic policies.

- Third, the decision to hold a referendum could complicate the ratification process in other EU member states where the fiscal treaty is already a very contentious issue. This is not likely to prompt additional referenda, but could lead to a more intense political debate on the fiscal treaty in national parliaments or in the framework of national elections (e.g. in France).

On the other hand, one should not exaggerate the potential effects of an Irish 'no'. First, the fiscal compact would still enter force and other eurozone countries would have to adhere to and implement the provisions laid down in the treaty – which would allow the ECB and triple-A countries (especially Germany) to continue arguing that the EU is progressing towards some form of fiscal union. Second, the Irish could be asked to vote for a second time and Dublin's eurozone partners could think of 'real' and 'symbolic' concessions in return for a 'yes' in a second referendum. Third, Ireland and the countries of the euro zone, could try to identify alternative ways to continue lending money to Dublin, especially if the EFSF were to stay in place longer than expected.

The second Greek rescue package – green light amid many uncertainties

Contrary to many other EU Summits since 2010, Greece did not preoccupy this year's Spring European Council. However, EU leaders briefly discussed the latest developments and in a separate statement, heads of state or government of the euro area declared that they welcomed progress made with respect to the new Greek programme and the agreed prior actions.

The overall atmosphere at the Summit concerning Greece was much more positive than in the weeks before the March European Council, when EU officials and national policymakers raised doubts as to whether the country would receive a second bailout and strongly criticised the Greek authorities, saying that Athens was not sufficiently implementing the programme agreed with the Troika (Commission, IMF, ECB). The tone was markedly different in the framework of the March Summit. On his way out of the Eurogroup meeting, which ended just before the European Council began, German Finance Minister Wolfgang Schäuble, one of the most critical voices in the weeks ahead of the Summit, heralded the "tremendous efforts" made by Greece.

The 'Greek issue' not only dominated the weeks and days before the Spring Summit, but is also likely to remain high on the agenda in the days and weeks to come. The positive assessment of the Euro 17 paves the way for the Eurogroup to give a final 'green light' to a second Greek bailout package shortly after the end of the first phase of the writedown of Greek private debt, which ends on 8 March.

The second Greek package will be worth around €130 billion until 2014, with loans coming from other euro countries (mostly via the EFSF) and from the IMF, although the latter still has to decide on the actual size of its contribution at an IMF meeting on 13 March. The Fund's financial support is widely expected to be (much) smaller than in the first Greek bailout. The loans will mainly be used to finance the restructuring of Greek debt, including the cost of 'sweetening' the actual bond swap (around €30 billion), paying the accrued interest (around €5.5 billion) and providing a means to recapitalise Greek banks (€23 billion), which will suffer huge losses due to the writedown of Greek sovereign debt.

In return for the second package, Athens must achieve the fiscal consolidation targets agreed with the Troika, carry out the privatisation plans and implement bold structural reforms in the labour, product and services markets. The Greek government has also agreed to stronger on-site monitoring by the Commission to assist the Troika in assessing the conformity of measures taken by the Greek authorities to assure the timely and full implementation of the programme. Athens has also accepted demands to set up a segregated account, which will at any time include sufficient funds to secure debt servicing for the following quarter. In addition, the Greek authorities have agreed to introduce by April 2012 a provision in the country's legal framework ensuring that top priority is granted to debt servicing payments. These measures intend to reassure Greece's partners that the country will stick to its commitments and continue to service its debt obligations *vis-à-vis* public lenders.

Athens has, however, strongly rejected a German idea leaked in January 2012 to install an 'austerity commissioner' appointed by the Eurogroup and equipped with wide-ranging powers to oversee the Greek budget – an idea that had not only been strongly opposed in Athens but also in other capitals and by highly-ranked EU officials due to sovereignty considerations. Greek Prime Minister Lucas Papademos – supported by Commission President Barroso – has also rejected proposals brought forward by Jean-Claude Juncker just ahead of the Summit to appoint a special European commissioner dedicated to the 'reconstruction' of Greece. Prime Minister Papademos argued that "the new economic programme for Greece will be implemented by the Greek government". And President Barroso rejected the idea of a 'reconstruction commissioner', arguing that Greece was a priority not just for one commissioner but for the entire college.

The actual disbursements of the second rescue package are subject to a successful voluntary writedown of Greek debt. After long and intense negotiations with the International Institute of Finance (IIF), which represents private bondholders, the Greek authorities presented their offer to private investors holding government bonds worth €206 billion on 24 February 2012, much later than originally scheduled.

The offer goes beyond the agreement initially reached with the IIF on the margins of the EU Summit on 26/27 October 2011, as it includes a bigger writedown of the debt's nominal value – 53.5 instead of the original 50 per cent – and lower interest rates. According to the offer, 31.5 per cent of the debt will be swapped into new Greek bonds with a maturity of between 11 to 30 years, subject to UK (not Greek!) law. The remaining 15 per cent will be exchanged into EFSF bonds with a maturity of one to two years ('sweetener') and the accrued interest on Greek government bonds until 24 February 2012 will be 'paid out' by the Greek authorities (around €5.5 billion). Overall, the writedown is estimated to amount to a 75 per cent reduction in 'net present value' (i.e. the present value of future cash flows minus the bond purchase price) of Greek government bondholdings. The average interest rate of new Greek bonds will be 2.63 per cent on average for the first eight years (2012-2020) and 3.65 per cent for the entire 30-year period. The offer also includes a 'GDP clause', according to which interest rates for the new Greek bonds will increase by up to 1 per cent should the country's economy performs above a certain level.

The success of the bond swap cannot be taken for granted, as it is unclear how many private bondholders will 'voluntarily' sign up. Many banks and other financial institutions have over the course of the last few months sold a great share of their Greek bonds to hedge funds and other speculators, who were not represented in the negotiations with the IIF; and it seems likely that many of them will not sign up to the offer.

If the participation rate is below 75 per cent, the PSI will (most likely) fail. If 75-90 per cent sign up, the Greek authorities could – after consulting eurozone partners in the framework of a Eurogroup teleconference on

9 March – activate the so-called collective action clauses (CACs), which were retroactively inserted into rules governing Greek sovereign bonds in February 2012 and which can be used to oblige sovereign bondholders to suffer a writedown.

However, the use of CACs could trigger pay-outs of CDS (credit default swaps), should the so-called 'EMEA Determinations Committee', a committee that includes ten banks and five investment funds which meets under the auspices of the International Swaps and Derivatives Association (ISDA), decide that a Restructuring Credit Event has occurred. EU governments, the ECB and major banks have repeatedly warned of the potential negative implications of CDS activation. However, more and more experts hold that the activation of CDS (with a net value of around €3-3.5 billion) would in the current Greek case not threaten the stability of the financial system. Some have even warned that a decision not to trigger pay-outs could undermine the credibility of the CDS instrument, with negative consequences for sovereign bond markets in Europe and beyond.

Finally, CACs will not be activated if the participation rate is above 90 per cent. But every percentage point below full participation will reduce the writedown benefit, and Greek authorities together with their eurozone partners will have to identify ways to close the resulting financial gap.

Beyond the immediate questions related to the bond swap, there are a number of other financial and economic uncertainties, which will remain even after a successful writedown of Greek private debt:

- **Will Greek debt levels eventually reach a sustainable level?** The Eurogroup assumes that Greece's public debt ratio can be put on a downward path from its current level of over 160 per cent to 120.5 per cent of GDP by 2020. This assessment seems very optimistic. The latest Debt Sustainability Report produced by the Troika in mid-February 2012 suggests that Greek debt levels may well stay above the 120 per cent targeted by European leaders in October 2011. But even if one assumes that the debt ratio can be reduced to around 120 per cent, would such a debt level really be sustainable? Most economists hold that debt levels above 100 per cent are still too high, especially if a country's growth prospects are rather limited.

- **Will Greece require a third rescue package?** The latest Troika report assumes that the country will require additional external funding for the period 2015-2020 and even German Finance Minister Wolfgang Schäuble and Eurogroup President Jean-Claude Juncker have not ruled out a third Greek rescue package if Greece is unable to return to the markets after 2014 – which seems rather unlikely.

- **Will Greece eventually require another restructuring of its debt, this time also involving the public sector?** Such official sector involvement (OSI) could include loans provided by other eurozone partners bilaterally or through the EFSF, as well as bonds held by the ECB and national central banks. But would public lenders, who after the PSI will hold the vast majority of Greek debt, be ready to resign from large parts of their outstanding loans? And how would the wider public in creditor countries react to such losses?

- **How can Greece escape recession to eventually grow itself out of the crisis?** The country is in the fifth year of a deep economic downturn (-6.8 per cent alone in 2011) and predictions indicate that negative growth will continue in 2012 (more than 4 per cent), due to additional austerity measures and tax increases. Greece has to promote structural reforms and needs to further cut public expenditure in order to regain competitiveness and to achieve a primary surplus in 2013 (the primary deficit has been substantially reduced from 10.4 per cent in 2009 to 2.4 per cent in 2011, and is projected to be at 1.0 per cent in 2012).

The country is not likely to stop the downward economic spiral without external growth stimulators. The reduction of co-financing rates to speed up access to EU funds, the fact that the second Greek programme is more focused on restoring competitiveness and growth, and the fact that euro leaders have in the framework of the March Summit expressed their support for concrete and specific measures to enhance growth outlined by Prime Minister Papademos and President Barroso, including EU structural fund support for key infrastructure projects and measures to improve the business environment, boost liquidity for SMEs and promote employment and training: all these are moves in the right direction, but more needs to be done to assist not only Greece but also other 'problem countries'.

Separate treatment of productive investment in austerity programmes; the establishment of a temporary investment fund – a new Stability and Growth Fund (SGF); increased use of new loan/private-public partnership instruments (e.g. through Project Bonds or "growth bonds", as President Barroso now calls them); and/or a refocusing of the EU budget – all these measures could boost growth and employment and increase the feasibility of reform, thereby helping Greece and other problem countries to grow out of the crisis.

Beyond all these economic aspects, Greece might face also a number of political uncertainties in the months to come. Elections will (most likely) be held in late April/early May 2012. The outcome of these elections is still highly uncertain. The latest polls indicate that nine parties could enter the Greek parliament and that the two parties – PASOK and Nea Demokratia – which have dominated the political scene in Greece during the last few decades will most likely suffer severe loses. It is impossible to provide a sound prognosis as to which parties will be able and willing to form the next coalition government.

There are fears outside Greece that the next Greek government might not stick to the programme underlying the second bailout package or even turn its back on the EU. However, these fears seem rather unwarranted. The vast (silent) majority of Greeks (around 65-70 per cent) understand the urgency of the moment and want the country to remain within the euro zone; this could at the end of the day influence their voting decision, i.e. 'push' them to vote for those parties with a clear pro-European vocation. In any case, one should expect any new government to attempt to 're-negotiate' with its eurozone partners; not in order to change the overall objectives and basic content of the programme, but to add elements to the crisis recipe, which will help the country to exit the negative spiral of uncertainty and economic downturn.

No decision on increasing Europe's financial firepower (yet)

Due to opposition from the German coalition government, EU leaders have not been able to come to an agreement on whether and how to extend the firepower of the temporary and permanent rescue mechanisms (EFSF/ESM), despite strong pressures from within and outside Europe. A separate Euro Summit meeting on Day 2 of the Spring European Council, during which the 17 heads of state or government were to deliberate the issue, did not take place.

Aiming to increase investor confidence and to further calm down markets, EU officials and institutions (including the President of the European Council, the President of the Eurogroup, the European Commission, the ECB and the European Parliament) and almost all EU leaders are in favour of increasing the size of the euro zone's financial 'firewall'. The group of supporters includes also three of the four triple-A countries: Finland, Luxembourg and the Netherlands, whose governments have publicly called for an increase to €750 billion by either keeping in place the temporary rescue fund (EFSF), which still has at its disposal around €200-250 billion, or increasing the overall size of the permanent ESM, currently limited to €500 billion.

Strong pressure to install a financial 'bazooka' has also come from outside Europe. Led by IMF President and former French Finance Minister Christine Lagarde, and supported by Brazil, China, India, Japan, the United States and others, the International Monetary Fund and non-European G20 states have been calling intensively on Europeans and particularly on Germany to substantially increase Europe's firewall, arguing that this move would also determine whether non-Europeans will be ready to take a decision to also increase the IMF's own firepower against contagion to about $1,000 billion in mid-April – thereby creating a combined financial firewall of up to €1,500 billion.

Germany in December 2011 agreed to review the size of the firewall in March 2012, and other governments and EU officials had hoped that Berlin would show some flexibility following the vote on the second Greek package in the Bundestag just days ahead of the Summit – not at least also as a *quid pro quo* for the readiness of Germany's partners to accept the new fiscal treaty.

But at the Summit, the German coalition government stuck to its 'no', arguing that the EFSF and ESM were never intended to be big enough to rescue Italy or Spain, that an increase of the ESM beyond the current €500 billion was not necessary, and that an increase would send the wrong signals, creating disincentives for problem countries to continue reforms and expenditure cuts.

However, just ahead of the Spring European Council, Berlin seemed to carefully indicate its readiness to move on the issue: an article in the German newspaper *Süddeutsche Zeitung* reported that Chancellor Merkel might change her position with respect to the size of European rescue funds, as the rest of the world holds that an increase is important for "psychological reasons"; the German government would not be able to resist this kind of collective pressure.

But before taking a final decision, Berlin wants to await developments regarding Greece. In essence, however, Chancellor Merkel wants to gain time to 'convince' her own coalition government and public opinion, where she is facing strong opposition with respect to a further increase of Germany's financial commitments. Particular resistance comes from the 'sister party' of Chancellor Merkel's CDU, the Bavarian CSU, which faces regional elections in 2013 and which has defined an increase of German guarantees as a 'red line'.

In their separate statement the 17 euro leaders once again confirmed their commitment to "re-assess the adequacy of the overall ceiling of the EFSF/ESM" by the end of March. It seems likely that a compromise solution to increase the euro zone's financial firepower will be reached in the upcoming weeks and thus well ahead of the crucial IMF meeting in April 2012. And it seems that the German government would be ready to accept a solution according to which the EFSF and the ESM will run in parallel for (at least) one year. President Van Rompuy and Eurogroup President Juncker indicated in their press conferences after the European Council meeting that a decision to increase Europe's firewall could be taken at the level of finance ministers, thus not requiring a separate Euro Summit later this month.

Irrespective of the overall size of future European rescue mechanisms, euro leaders took a decision at the Spring Summit to accelerate the payment of paid-in capital for the ESM, by starting with two tranches and not one in 2012; the original plan had foreseen that the €80 billion of paid-in capital would be disbursed in five equally big yearly tranches.

Serbia, Schengen enlargement and the re-election of Herman Van Rompuy

Beyond the realm of economy, EU leaders also discussed and took decisions with respect to the granting of candidate status to Serbia and the enlargement of the Schengen area to Bulgaria and Romania.

Candidate status for Serbia

After failing to do so at their Summit in December 2011, EU leaders finally decided to grant Serbia the status of candidate country. The date for opening accession negotiations remains open, but talks could start in December 2012 if Belgrade continues reforms (especially in areas such as justice, freedom and security, the environment, agriculture and rural development), and keeps improving its relationship with Pristina. In his press conference after Day 1 of the Summit, President Van Rompuy stated that he hopes that the attribution of the candidate status will "encourage Serbia to undertake further efforts in order to meet the political and economic criteria for EU membership".

During a meeting of EU foreign ministers in the week of the Summit Romania had threaten to veto the decision on candidate status, arguing that Serbia was mistreating the Vlach minority. However, Romanian President Traian Basescu dropped his opposition just ahead of the European Council meeting, saying that the issue had been "resolved" after Romania and Serbia had signed a bilateral agreement at ambassadorial level providing for better protection of minority rights. Diplomats from other member states and commentators argued that Romania had raised objections only to press other EU countries, especially the Netherlands, to drop opposition regarding Bucharest's accession to the Schengen area (see below). During his press conference, President Van Rompuy denied that the two issues had been linked.

Enlargement of Schengen to Bulgaria and Romania

The European Council made some progress with regard to the accession of Bulgaria and Romania to the Schengen area. After intense consultations in the weeks ahead of the March Summit, EU leaders agreed on a roadmap asking the Justice and Home Affairs Council to adopt a decision in September 2012. Ministers have also been asked to identify and implement measures contributing to the success of the process in order to reassure some member states – most notably the Netherlands – that Schengen accession will not cause any problems. In his press conference after Day 1 of the Summit, President Van Rompuy thanked Bulgarian Prime Minister Boyko Borisov, Romanian President Traian Basescu, Dutch Prime Minister Mark Rutte and Danish Prime Minister Helle Thorning-Schmidt (representing the current Council Presidency) for their constructive attitude during a final exchange of views on the Schengen question just before the start of the Summit.

However, during the EU Summit Prime Minister Rutte declared that Bulgaria and Romania, which joined the EU in 2007, are still not ready to join the Schengen area. Rutte informed his peers that his government would not agree to the accession of Bulgaria and Romania before the publication of the results of the Commission's yearly monitoring report on the fight against corruption and organised crime, which is due in July 2012.

The government in The Hague has been arguing that opening the border would be premature as long as Bulgaria and Romania have not done enough to fight corruption and organised crime. Sofia and Bucharest have, on the other hand, accused the Netherlands of applying double standards by applying tougher criteria on the two Balkan countries. Danish Prime Minister Thorning-Schmidt indirectly supported this view when stating that the goalposts should not be moved in the midst of an accession process.

The final agreement reached and laid down in the Summit Conclusions provides for "a conditional accession to Schengen later this year". It is the first time that EU leaders have agreed on a concrete date for a decision on this highly contentious issue, thereby increasing the pressure on the Dutch government.

(Re-)election of Herman Van Rompuy

As expected, EU leaders re-elected Herman Van Rompuy as president of the European Council for another 2.5 years until November 2014 and asked him to also chair Euro Summit meetings that bring together the heads of state or government of the euro countries.

In his 'acceptance speech' President Van Rompuy thanked EU leaders "for the trust that you have placed in me". The economy, he said, will remain his top priority during his second mandate. He and other EU leaders "must convince people across Europe that their sacrifices in these crisis years were not made in vain. (…) It is my and our role that Europe again becomes a symbol of hope, of a better future for all."

Global and foreign policy issues

With respect to global and foreign policy issues the Summit conclusions refer to (i) three upcoming international summits, (ii) the relationship with the EU's Southern Neighbourhood, (iii) the appalling developments in Syria, (iv) developments with respect to Somalia, (v) progress in the framework of Eastern Partnership, and (vi) the deterioration of the situation in Belarus.

EU leaders agreed on a number of EU priorities with a view to the upcoming **G20 summit**, which will be held in Mexico on 18-19 June 2012, were informed of the state of play regarding preparations for the next **G8 summit**, to be held in Chicago 19-20 May 2012, and agreed on some key principles that will guide the EU's preparations for the **Rio+20** United Nations Conference on Sustainable Development in Rio de Janeiro on 20-22 June 2012.

The European Council discussed emerging trends and lessons learned from developments one year after the start of the Arab Spring. In more concrete terms, EU leaders agreed on six orientations that will guide the Union's further engagement towards its **Southern Neighbourhood**: (i) the EU will encourage all countries in the Southern Neighbourhood to undertake significant political reforms designed to build and consolidate democracy, establish and strengthen the rule of law and to uphold respect for human rights and civil liberties, with particular attention to women's and minorities' rights; (ii) the EU will place greater emphasis on assistance focused on governance and job creation; (iii) the Union is determined to offer more support to those partners that make progress towards democracy; (iv) the EU will continue to strengthen its partnership with civil society; (v) rapid progress is needed in the ongoing trade negotiations and in the preparation of negotiations for Deep and Comprehensive Free Trade Agreements that will progressively integrate partners' economies into the Single Market; and, finally, (vi) the dialogues on migration, mobility and security will be extended with a view to fostering people-to-people contacts, business contacts and mutual understanding; joint efforts will also be pursued to prevent illegal migration. The European Council has invited the Commission and the High Representative to present a roadmap by the end of 2012 to define and guide the implementation of the EU's policy *vis-à-vis* its Southern Mediterranean partners, listing its objectives, instruments and actions, focusing on synergies with the Union for the Mediterranean, and other regional initiatives.

EU leaders stated that they were appalled by the situation in **Syria** and demanded the immediate cessation of massive violence and human rights abuses inflicted on the civilian population. Strengthening the language of the original text, a new paragraph was added to the Summit Conclusions in which the European Council stated its determination to ensure that those responsible for the atrocities being committed in Syria be held accountable for their actions and that the EU coordinates closely with and assists those working to document these appalling crimes. EU leaders called on President Assad to step aside to make room for a peaceful transition, for the sake of the country. The European Council also reiterated the importance of full and unhindered access for independent humanitarian agencies, recalled its support for the efforts of the League of Arab States to end the violence in Syria, lends full support to the missions undertaken by former UN Secretary-General Kofi Annan, and supports the launching of the Group of the Friends of the Syrian People and the conclusions of its first meeting in late February 2012. Finally, the European Council called on all members of the UN Security Council, particularly Russia and China, who had vetoed a stronger UN Security Council Resolution in early February 2012, to work together in an effort to stop the violence, and recognises the Syrian National Council as a legitimate representative of the Syrian people.

The heads of state or government also welcomed the **Somalia** Conference held in London on 23 February 2012, invited the Council, the Commission and the High Representative to maintain a comprehensive engagement with Somalia, and asked the Foreign Affairs Council to report back to the European Council in October 2012 on the implementation of agreed actions.

The European Council Conclusions welcomed progress achieved by the **Eastern Partnership** in furthering political associations and economic integration with the EU. EU leaders looked forward to the Eastern Partnership Roadmap with a view to the next Eastern Partnership Summit in the second half of 2013.

Finally, EU leaders expressed their serious and deepening concern over the further deterioration of the situation in **Belarus** and welcomed the Council's decision to extend the list of those targeted by travel bans and asset freezes. The European Council reiterated the Union's commitment to strengthening its engagement with civil society and to supporting the democratic aspirations of the Belarusian people.

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