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Post-Summit Analysis

The bumpy road to economic union

Summary

The political atmosphere ahead of the European Council on 28-29 October had been poisoned by the Franco-German Deauville Declaration. But although the Summit was far from plain sailing, EU leaders in the end agreed on a number of key issues related to the reform of European economic governance. However, as this EPC analysis explains, there are still many uncertainties and open questions related in particular to the establishment of a new permanent crisis mechanism and the 'necessity' of changing EU Treaties.

Full report

The reform of European economic governance dominated the European Union's political agenda before and during the 28-29 October EU Summit. After difficult and sometimes heated debates, EU leaders not only endorsed the final report of the Task Force headed by European Council President Herman Van Rompuy, but also agreed on the need to amend the EU Treaties to set up a permanent crisis mechanism (PCM) to replace the *ad hoc* arrangements of the €110bn bail-out package for Greece and the €440bn rescue mechanism for the entire euro zone running out in 2013.

But this was far from plain sailing. The political atmosphere had been poisoned in the weeks and days before EU leaders gathered in Brussels, with the agreement struck between President Nicolas Sarkozy and Chancellor Angela Merkel in the seaside French city of Deauville on 18 October coming under heavy fire both in national capitals and in Brussels.

Under the deal announced just ahead of the Task Force's final meeting, Chancellor Merkel accepted French demands to give governments more control over the imposition of sanctions in the framework of a renewed Stability and Growth Pact (SGP). In exchange, President Sarkozy agreed to back German calls for an amendment to the EU Treaties, which Berlin deems necessary to avoid a legal clash with the German Constitutional Court in Karlsruhe.

The Franco-German declaration was heavily criticised from all sides and for many different reasons. Some argued that discussing the PCM deflected attention from the need to avoid a fiscal crisis similar to that experienced in the first half of 2010. Economic and Monetary Affairs Commissioner Olli Rehn explicitly warned of the danger of 'moral hazard', arguing that countries might not have the proper incentives to abide by stricter deficit rules if they knew they could tap into a common rescue mechanism.

Others, especially in Austria, the Netherlands and Germany (including in Chancellor Merkel's own government and party) feared that a PCM could undermine the 'no-bail-out' clause enshrined in the EU Treaties (Article 125 TFEU) and lead to a 'transfer union'.

European Central Bank President Jean-Claude Trichet openly voiced his discontent, arguing that the Franco-German deal could imply a step back from the idea of semi-automatic sanctions included in both the Task Force report and the legislative package proposed by the European Commission on 29 September.

Policy-makers in Sweden, the Netherlands, Finland and other northern countries were disappointed and shocked by Germany's decision to bow to French calls for greater political involvement in decisions on sanctions. But officials in Berlin argued that without the deal with France, there might be no agreement at all on new and tougher rules. Belgium, Italy, Spain and other heavily indebted countries would have also opposed near-automatic sanctions without the possibility of some political intervention at the highest EU level.

The idea of amending the EU Treaties was heavily criticised across the EU and by individual Commissioners (in particularly Olli Rehn and Viviane Reding). After the demise of the Constitutional Treaty and the difficulties surrounding the ratification of the Lisbon Treaty, there were fears that a new attempt to amend the Treaties would once again lead to years of navel-gazing and could open up a Pandora's Box, with a flurry of calls for a more comprehensive reform of the Union's primary law.

Most EU Member States criticised what they saw as the inappropriate manner and timing of the Merkel/Sarkozy initiative, coming as it did just ahead of the Task Force's final meeting. The Franco-German deal risked unravelling the compromise reached in the Task Force and gave the impression that the two countries were trying to run the EU by "diktat". Some even indirectly accused France and especially Germany of blackmail; i.e. of suggesting that if other EU governments were not ready to change the Treaties, Berlin and France might not be available after 2013 when the current rescue mechanisms run out.

The strongest criticism was directed at the German proposal, endorsed by the French, to temporarily suspend the voting rights of Member States deemed guilty of a severe breach of the "basic values" of Economic and Monetary Union (EMU). Many thought that the idea of suspending voting rights in cases of 'fiscal misbehaviour' was immoral, humiliating and incompatible with national sovereignty. The proposal was particularly attacked by smaller EU countries, which doubted that it would ever be applied to bigger Member States. Chancellor Merkel, on the other hand, pointed out that the EU Treaty already allows for the suspension of voting rights in the Council in the event of a "serious and persistent breach" of the Union's core values.

As a result of all this, the political atmosphere before the EU Summit was tense. The political symbolism of the Deauville meeting had created resentments between smaller and larger EU Member States and between fiscally-restrained northerners and heavily-indebted southerners. The negative reaction to the Merkel/Sarkozy agreement once again showed the limits of the old Franco-German engine and is a strong indication for the increasing distrust between EU capitals, and especially towards Germany. Berlin's EU partners still have to figure out how to accommodate and react to a 'new Germany' which is more pragmatic, less visionary and more driven by narrow national economic, political and financial interests.

Cornerstones of economic governance reform

But despite all the problems and controversies surrounding the Summit, the 27 Heads of State and Government were ultimately able to strike a compromise late on day one, taking a number of key decisions related to the content and process of economic governance reform:

- *Endorsement of Task Force report and fast-track procedure:* Implementation of the Task Force report will – according to the Summit Conclusions – increase fiscal discipline, broaden economic surveillance, deepen coordination and set up a robust framework for crisis management and stronger institutions. The compromise laid down in the report still needs to be implemented through secondary legislation proposed by the Commission and adopted by the Council and European Parliament. The European Council has called for a 'fast track' approach to this, asking the Council and Parliament to reach agreement on the Commission's legislative proposals by summer 2011.

- *Creation of a permanent crisis mechanism (PCM) and limited treaty change:* EU leaders agreed on the need to establish a permanent crisis mechanism "to safeguard the financial stability of the euro area as a whole". The Commission will undertake, in close cooperation with President Van Rompuy, "preparatory work on the general features of a future new mechanism". The Summit Conclusions state that special emphasis should be given to (i) the role of the private sector; (ii) the role of the International Monetary Fund (IMF); and (iii) the strong conditionality under which the mechanism will operate. EU leaders also invited President Van Rompuy to undertake consultations with EU leaders and the Commission President on a limited treaty change to establish a PCM. The Summit Conclusions explicitly mention that Article 125 TEU, which enshrines the so-called 'no bail-out' clause in the Treaties, should not be modified.

- *Timing:* The European Council will revert to the issues related to the PCM at its December meeting to take final decisions on both the outline of a crisis mechanism and a limited treaty amendment, so that any change can be ratified by mid-2013 at the latest.

- *Suspension of voting rights:* Despite strong opposition from a vast majority of EU governments and contrary to some premature reports in the media, the Summit Conclusions still refer to the issue of suspending voting rights in the Council. In somewhat cryptic fashion, they state that President Van Rompuy "intends to … examine in consultation with the Member States the issue of the right to participate in decision-making in EMU-related procedures in case of a permanent threat to the stability of the euro zone as a whole". This paragraph was a concession to Chancellor Merkel, who is still defending the idea in the face of fierce opposition from almost all sides.

EU leaders also touched on the question of how to include the costs of pension reform when calculating public debt. This is an issue of particular concern for nine countries particularly in Eastern Europe: Bulgaria, Czech Republic, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Sweden. They argue that the high short-term cost of moving from public to private pension schemes should not be included in EU calculations of the levels of public debt. Other countries, notably Germany, are opposed to changing the methodology for calculating debt as they fear that this could undermine budget discipline. However, following threats from the nine countries to block measures related to economic-governance reform, EU leaders agreed to add a passage to the Summit Conclusions inviting the Council to speed up work "on how the impact of pension reform is accounted for in the implementation of the Stability and Growth Pact".

Some progress, numerous uncertainties, and many open questions

It is worth taking a closer look at some of the more significant innovations related to Stability and Growth Pact reform, the introduction of a macroeconomic surveillance system and the establishment of a permanent crisis mechanism.

(1) A stricter Stability and Growth Pact III

The implementation of the Task Force's recommendations, which are very close to the Commission proposals, would create a third version of the Stability and Growth Pact (SGP). The 'SGP III' would be a tighter version of the original Pact set up in 1997, which was watered down in 2005 after Paris and Berlin refused to abide by the rules of the original SGP. In addition to introducing a "European semester", already agreed at the September Summit, the key innovations designed to improve fiscal discipline are:

- *Inclusion of public debt:* The Task Force report recommends that surveillance should in future not only concentrate on a country's current account deficit, but also on the overall level of public debt. As a result, Member States might face an Excessive Deficit Procedure even if their deficit is below 3%, if their overall debt has not been put on a "satisfactory declining path".

- *More sanctions:* The Task Force report suggests progressively applying a wider range of sanctions and measures in both the preventive and corrective arms of the SGP. The list of potential sanctions shall include both reputational and financial measures: (1) Reputational sanctions: When a Member State does not implement a Council recommendation, the Council and the Eurogroup would formally report to the European Council. When a Member State is subject to enhanced surveillance, the Commission will have the right to conduct on-site monitoring missions (in liaison with the ECB and ERM II participants); (2) Financial sanctions: The Task Force suggests new financial enforcement measures, including interest-bearing deposits, non-interest bearing deposits and fines. These measures will, in the first instance, only be introduced for euro-zone countries (on the basis of Article 136 TFEU).

- *Greater "automaticity":* The decision-making procedure for the new financial enforcement measures should, according to the Task Force, ensure a higher degree of "automaticity" through the introduction of a "reverse majority rule". These decisions should be based on Commission recommendations, which will be considered adopted unless a qualified majority of Member States vote against the recommendation in the Council within a certain deadline. The reverse majority rule does not, however, apply for later-stage sanctions; i.e. increased fines for persistent lack of compliance. In these cases, the usual Council voting rules will continue to apply. In general, the concrete level of automaticity is not clear yet, as the detailed practicalities of the new decision-making rules still need to be defined through the legislative process, involving not only the Commission and the Council but also the Parliament, which up till now has been an outspoken advocate of more quasi-automatic sanctions as proposed by the Commission. It remains to be seen how the Franco-German agreement to impose more political control over sanction mechanisms will manifest itself in secondary legislation.

It is too early to make a final judgement about the future Stability and Growth Pact. Details of the new rules have not yet been settled and the Pact's value will only become apparent through practice. However, there are a number of principal concerns which deserve to be mentioned:

- *Sanctions, sanctions, sanctions, but no incentives:* The new rules rely solely on sanctions to ensure greater fiscal discipline. Calls for incentives to 'motivate' governments to abide by the Pact's rules have again been disregarded.

- *Practicability and applicability:* Will or how will the new sanctions be applied in practice? None of the sanctions already foreseen in the Maastricht Treaty and the first version of the SGP have ever been used. One could argue that this is exactly why the SGP-III foresees a higher degree of automaticity. However, there are still doubts about whether sanctions will really be applied in the future – and whether they will apply equally to all EU countries whatever their economic and political weight.

- *Effectiveness:* Will sanctions imposed on an EU partner country really be effective? Does it really make sense to fine a country in financial trouble? Or will such sanctions not only worsen the financial situation but also provoke counter-productive, anti-European feeling which, in the end, will undermine a country's readiness and ability to return to the path of fiscal virtue.

- *Exclusion of private debt:* The SGP-III remains focused on the level of public debt, but ignores the relevance of private-sector credit growth. The European debt crisis has provided ample proof that an increase in private debt fostered fiscal problems by fuelling external and domestic imbalances in some EU countries, most notably in Spain and Ireland. It is noteworthy that before the crisis, both countries were well below the 60% debt rate and had low deficits or even budget surpluses.

(2) A new economic surveillance mechanism – innovative but problematic

The European sovereign debt crisis has demonstrated that compliance with the SGP is important but by no means sufficient. The Task Force report thus rightly proposes an annual assessment of the risks of macroeconomic imbalances and vulnerabilities, given that persistent and large imbalances and divergences in competitiveness, particularly among euro-zone countries, are a major threat to the functioning of EMU, not only in theory but also in practice.

The new surveillance framework shall, according to the Task Force, take a two-stage approach:

(i) An **annual assessment** of the risk of macroeconomic imbalances and vulnerabilities on the basis of a scoreboard covering a limited number of indicators and economic analysis. If the alert mechanism signals actual or potentially excessive imbalances, the Commission shall conduct an in-depth analysis, which could include country surveillance missions in liaison with the ECB and ERM II Member States.

(ii) The introduction of an **enforcement framework**, allowing the Commission to address early warnings directly to the Member States concerned. In the case of "particularly serious imbalances", the Council shall decide to place Member States in an "excessive imbalance position" based on a Commission recommendation. To correct imbalances, the Council should have the right to address a set of policy recommendations to the Member State concerned, which would have to report regularly on the implementation process, and the Commission would monitor implementation (including surveillance missions). If recommendations are not implemented, this should be made public and reported to the European Council. For euro-zone members, the enforcement mechanism should ultimately lead to sanctions in case of repeated non-compliance.

President Van Rompuy argues that the creation of the new macroeconomic surveillance framework is the "biggest innovation" in the Task Force report. In theory this is true, but there a number of reasons to question whether or to what extent it will succeed in practice.

First, neither the Task Force nor the Commission's proposals give details of the indicators that will be used to draw up the competitiveness scoreboard. The Task Force report merely states that they shall be simple, measurable and available. Identifying the conditions for opening an excessive imbalance procedure thus risks becoming a very subjective exercise.

Second, in light of past experience, there is reason to doubt that the Commission will have the political courage and clout to address certain macroeconomic imbalances and an increasing divergence in competitiveness within the EU.

Third, there are grounds for questioning the effectiveness of the early warning system proposed by the Task Force. Will it really detect imbalances at an early stage? Experience shows that imbalances and vulnerabilities are often not detected early on, which makes it even more difficult to reverse developments already well under way.

Fourth, even if one assumes that such imbalances and vulnerabilities are detected, will the Commission or Council be able to 'persuade' a Member State government to counter a potential imbalance or vulnerability? As Wolfgang Münchau asked in the *Financial Times*: "Would Spain have imposed bubble-bursting real-estate taxes after receiving a high-level delegation from Brussels?" The answer is far from certain, especially if one of the bigger Member States is involved.

This is one reason why policy-makers and political observers in smaller EU countries question whether the surveillance mechanism will be applied equally to all Member States. Would the Commission, for example, have 'criticised' Germany for its large current-account surplus and increased competitiveness, which is not only linked to social reforms, technical innovations and productivity

increases, but also to low domestic demand and increased competitiveness resulting from, among other things, a long-term policy of restrictive wage increases?

(3) Permanent crisis mechanism – more questions than answers

There are many uncertainties surrounding the introduction of a permanent crisis mechanism (PCM). It is clear that some sort of crisis mechanism is needed to replace the European Financial Stability Facility (EFSF), an *ad hoc* emergency measure established after a decision taken by the Ecofin Council on 9 May to safeguard financial stability in Europe. The EFSF, a private company set up outside EU institutions, can issue triple-A bonds guaranteed by euro-zone members for up to €440bn for on-lending to euro-zone countries in difficulty. It will have to be replaced, because it was deliberately given a limited three-year lifespan and because the German government has repeatedly declared that it is not ready to prolong its existence after 2013.

Some EU governments favour an extension of the current mechanism. Berlin, however, has two main arguments against this. One has to do with its justified fear that this could be successfully challenged in Germany's Constitutional Court – although it is less clear whether the EFSF could also be challenged at Karlsruhe under an amended Article 122 TFEU (see below).

The second argument relates to the fact that the current mechanism puts the main burden on euro-zone countries and their taxpayers rather than on private lenders. Germany, supported especially by the Netherlands and now also France, insists that private investors should be obliged to carry a share of losses if euro-zone countries have to resort to the crisis mechanism. Chancellor Merkel has also explicitly stated that investors should share responsibility if a country's debt had to be restructured.

But how could a (new) more permanent crisis mechanism look like? How would it function and under which conditions would it be activated? And how could it affect financial markets? These and many other questions need to be answered in the next couple of months.

The Task Force report merely states that the precise features and operational structure of the PCM will require further work. The Summit Conclusions declare that the European Council welcomes the Commission's intention to do some "preparatory work on the general features of a future new mechanism", and that EU leaders want to take final decisions at their December Summit. German officials say Finance Minister Wolfgang Schäuble will also come up with more concrete proposals "shortly".

In recent weeks and months, some initial ideas – developed mainly in Germany – have been suggested or leaked to the press. These suggest that the PCM could rest on two pillars:

(i) An **orderly insolvency procedure** for countries unable to service their debts. This should force private creditors to pay part of the costs related to a potential restructuring ('hair cut'). In return, lenders will receive a guarantee that a high proportion of the debt will be re-paid at some point in time. Media reports in July suggested that a newly established "Berlin Club" would function as an international guarantor and ensure an orderly rescheduling of sovereign debt. This Club, which would function along the lines of the existing Paris or London Clubs (which cover the restructuring of debts between countries and between banks and states), would attribute a key role to the IMF and be composed either of G20 members or established within the euro-zone framework. Berlin argues that the possibility of sovereign default would not only increase risk-awareness among private creditors by compelling bondholders to share the cost of state bailouts. It would also force the markets to discipline governments by making them pay higher borrowing costs.

(ii) A **financial mechanism** capable of providing loans with strict conditions attached to them. The PCM's financial umbrella would have to be big enough to prevent another severe financial crisis in the euro zone, by averting financial panic in the country facing sovereign default which could easily spill-over into other Member States or negatively affect commercial banks.

Despite their vagueness, the ideas outlined above provide at least some indications of the nature and set-up of a PCM. However, many crucial questions remain unanswered:

- Would a mechanism, which includes an insolvency procedure, be able to avert or at least control the danger of a sovereign default in one euro-zone country destabilising other weaker members of euro area? How big must the financial umbrella be to avoid panic in the markets and minimise the risk of major banks failing?

- Would the possibility of default increase debt-servicing costs for highly indebted European countries? And would that not, in the end, aggravate the debt/deficit situation in many euro-zone countries? ECB President Trichet has warned that including private investors in the crisis mechanism could be "counter-productive" if it leads to a loss of confidence in existing debt. His warning is supported by the fact that the EU's decision to set up a PCM including an insolvency procedure has already affected the bond market, forcing up yields and the price of risk premiums on Portuguese, Irish and especially Greek debt.

- What economic and political price will a country have to 'pay' for using the PCM? What conditions will be attached to using it, and will weaker euro-zone countries be ready and politically able to accept the terms attached to an insolvency procedure? This might be particularly difficult if the national sovereignty of countries subject to an insolvency procedure is severely restricted. Noteworthy, the aim to restrict national sovereignty could be one reason why Chancellor Merkel continues to insist on linking the PCM to a possible suspension of voting rights in the Council.

- Will an orderly insolvency procedure ultimately compel the country concerned to abandon the euro? Or will a sovereign insolvency take place within the framework of the euro zone? If this is not possible, weaker Member States are likely to oppose the introduction of a PCM along the lines described above.

- Is this the right time to be talking about the creation of an insolvency procedure? Yes, a solution must be in place by 2013, but the current debate is fostering speculation about the possibility of a sovereign default of a euro-zone country. It is thus justified to ask whether this debate has come too early, given the persistent fragility of global and European financial markets – an argument also made by ECB President Trichet, who has warned of a premature debate about 'haircuts'.

The dangers and uncertainties of treaty reform

Despite strong initial opposition, all EU leaders have agreed in principle to a limited treaty change in exchange for the establishment of a PCM. This has been described as a "major victory" for Chancellor Merkel and might be seen as a justification, particularly by Berlin, for the political turmoil created by the Deauville Declaration.

But which parts and which article(s) of the Treaty might be affected? And how could this be done without substantially re-opening the EU's primary law? There is no straightforward answer to these questions. Much will depend on the specific nature and content of the PCM and on the degree of treaty change necessary to establish it.

The Commission argues that a more permanent crisis mechanism would be possible even without treaty change. However, Germany's request for (at least) an extension of Article 122 TFEU seems

justified, if the new crisis mechanism includes the possibility of granting financial assistance, and if EU governments do not want to change the no-bail-out rule enshrined in Article 125 TFEU.

Article 122 (already used to justify the setting-up of the EFSF) allows financial assistance to a Member State which is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control. The EFSF or any new crisis mechanism could be placed on a sound legal basis if Article 122 is extended to include the possibility of granting financial assistance as *ultima ratio* in the event that EMU's existence and stability is endangered.

The German government's second request, to make it possible to suspend voting rights temporarily, is much more problematic. Legally, this could be achieved by applying Article 7 of the EU Treaty, which foresees the suspension of voting rights in the Council in the event of a "serious and persistent breach" of the Union's core values. Article 7 was inserted into the Nice Treaty after the Austrian experience in early 2000, when Jörg Haider's far-right party joined the government and the EU lacked a legal instrument to isolate a Member State government.

Applying Article 7 to countries which disobey the rules of EMU would require an extension of the catalogue of values enshrined in Article 2 of the EU Treaty. However, this seems somewhat inappropriate, given that this Article refers to basic values such as human dignity, freedom, democracy, equality, rule of law etc.

It is also questionable whether the introduction of a PCM would need to be accompanied by the possibility to suspend voting rights. One could argue that this is a necessary 'ultimate punishment', but there are other ways to 'punish' a country which has not played by the rules both politically and economically, especially if the country concerned is obliged to seek help from the crisis mechanism and thus has to accept the strict conditions attached to it.

The Summit Conclusions state that limited treaty amendments should be ratified at the latest by mid-2013, a highly ambitious timetable considering how long it has taken to ratify treaty amendments in the past.

To simplify and shorten the procedure, the so-called *simplified revision procedure* introduced by the Lisbon Treaty (Article 48 TEU) could be used. This allows the European Council to adopt a unanimous decision amending all or part of the provisions of Part Three of the Treaty on the Functioning of the European Union. The European Council would be able to act fairly autonomously, although it would have to consult the European Parliament and Commission as well as the European Central Bank in the case of institutional changes in the monetary area. A European Council decision to amend the Treaties would enter into force only after it has been approved by the Member States in accordance with their respective constitutional requirements. The major advantage of this procedure is that it would be rather simple and not very time-consuming, provided that all EU governments and national parliaments support the relevant change to the Treaties.

The simplified revision procedure could potentially be used in the case of Article 122, which is included in Part Three of the TFEU, but cannot be applied in the case of Articles 2 or 7, as both are part of the Treaty on European Union and not of the Treaty on the Functioning of the European Union.

Articles 2 or 7 would thus have to be amended using the *ordinary revision procedure* (Article 48 TEU), which covers amendments to all EU Treaties. But this could be more time-consuming as it might even require a Convention including representatives of the national parliaments, the European Parliament and EU governments.

A decision not to convene a Convention in the framework of the ordinary revision procedure would require the European Parliament's consent, which will be difficult to obtain. MEPs already feel sidelined because the Parliament has not been involved in the Van Rompuy Task Force. Convening a Convention

would not only be much more time-consuming. Involving a plethora of national and European stakeholders could also open up the spectre of a more comprehensive treaty reform.

Another alternative, put forward most vocally by German officials, is to change the Union's primary law via Croatia's Accession Treaty – a legally applicable procedure that has been used in the past to amend EU Treaties even though the issues addressed were not directly linked to the accession of the country concerned. This would, however, be more complicated this time around, as the issue at stake – the introduction of a crisis mechanism – is not a mere 'technical' adjustment but a politically highly sensitive matter. It will thus be difficult to amend the Treaties through the 'back door' of an accession treaty. From the perspective of Zagreb, one should also consider the possibility that the issue could overburden the ratification of the Croatian Accession Treaty and thus endanger or at least postpone the entry of Croatia into the EU.

The greatest challenge to treaty change stems from the fact that any amendments to the EU Treaties must be ratified in all EU countries before they can enter into force. Obviously, the challenge would be greatest, if a treaty change becomes subject to a referendum in one or more member states.

As the details of a PCM are not clear yet, it is difficult to give a thorough prognosis. However, one could argue that a limited amendment of Article 122 would not, from a legal perspective, require a referendum in any Member State. However, from a political perspective, it is possible that one or more governments might still call a referendum to undermine a 'disliked' treaty change through a popular vote.

In contrast, potential changes related to the suspension of voting rights might not only face severe ratification problems in a number of parliaments, but would probably also require a referendum in one or more Member State – Ireland being the most probable case. And it would not be easy to persuade the citizens of a Member State which might be obliged to use the PCM at some stage to vote in favour of a severe restriction on its national sovereignty.

Finally, there is the question of what happens if a treaty amendment to introduce the new crisis mechanism cannot come into force till mid-2013, when the *ad hoc* mechanisms for Greece and the entire euro zone run out. Not having a PCM in place by then could severely destabilise financial markets. It is thus advisable to think of a 'Plan B' early on.

An unexpected clash over the EU budget

EU leaders agreed that the 2011 EU budget and the forthcoming Multi-annual Financial Framework (MAFF) from 2014 onwards should reflect the consolidation efforts being made by Member States to bring deficits and debts down.

The decision to add this point to the Summit Conclusions came after an unprecedented clash between European Parliament President Jerzy Buzek and UK Prime Minister David Cameron over the size of next year's EU budget.

President Buzek – supported by Commission President Barroso – had defended the Parliament's proposal for a 5.9% increase in the 2011 budget, arguing that the increase in the Union's tasks linked to the Lisbon Treaty justifies a higher EU budget. Mr Cameron's tough stance won support from a number of fellow leaders, including those from Austria, the Czech Republic, Denmark, Estonia, Finland, France, Germany, the Netherlands, Slovenia and Sweden, who agreed to send a joint letter to President Van Rompuy and Belgian Prime Minister Yves Leterme, holder of the EU's rotating presidency.

The letter states that the proposed 5.9% increase is "especially unacceptable at a time when we are having to take difficult decisions at national level to control public expenditure". The signatories insist that they will not accept an increase greater than 2.91% – the figure the Council agreed in August.

It still seems possible that a compromise around the 3% figure will emerge in the coming weeks. However, the clash between President Buzek and a large number of EU leaders is a foretaste of the harsh debates we are likely to witness and the 'political blood' that is likely to be shed during the upcoming negotiations on the next MAFF. The ongoing crisis and austerity measures in almost all Member States will widen the gap between net contributors and net recipients, and between some EU capitals and the Commission and Parliament. Many EU leaders will probably seize the opportunity to claim (alleged) victories and to portray themselves as defenders of their taxpayers' money. All this will make a rational debate about the size and direction of future EU budgets even more difficult than in the past.

Ahead of the G20 Summit – attempts to avoid 'currency' and 'trade wars'

EU leaders also agreed the Union's position for the G20 Summit in Seoul on 11-12 November and appealed to the G20 to avoid trade and currency wars. This warning comes against the backdrop of increasing fears of a race to the bottom, with major countries trying to outdo each other in beggar-my-neighbour currency battles. The EU and the US blame China for manipulating its currency to support its export-driven economy. US legislators are currently even debating a law that would allow for punitive tariffs on countries which undervalue their currencies. Washington is also critical of the nature and timing of the European exit strategy, arguing that budget austerity is being introduced too early and that there is still a risk of sovereign default in Europe, which could threaten the stability not only of the euro zone but also of a still fragile global financial system.

Chinese officials say the planned legislation to punish Beijing would amount to protectionism and in return blame the US for flooding the world with dollars through its policy of quantitative easing. Washington, on the other hand, wants the G20 group of leading economies to reach an agreement on specific guidelines on reducing trade imbalances. The Obama administration has already sought to forge consensus on a concrete numerical target for surpluses and deficits, suggesting a cap of 4% of GDP. But the proposal has run into strong opposition not only from export-oriented countries such as Brazil, China and Japan, but also from Germany. In a joint letter to the Heads of State and Government ahead of the EU Summit, President Van Rompuy and President Barroso argued that solving global imbalances does not require numerical targets on current account surpluses or deficits, but rather that "global imbalances are fuelled by exchange rate misalignments".

In the Summit Conclusions, EU leaders emphasise the need to keep markets open, avoid protectionism, inject momentum into the WTO Doha negotiations and avoid "engaging in exchange-rate moves aimed at gaining short-term competitive advantages".

It remains to be seen what kind of mediating role the EU and the Member States represented in the G20 can play in Seoul to avert a major currency and trade war, which would have devastating effects on the global economy and the global political landscape.

The EU's mediating position could be strengthened by the fact that Europeans accepted reforms of the IMF at the last G20 ministerial meeting on 23 October, agreeing to surrender two of their seats on the Fund's 24-member executive board to make way for emerging countries, which will also receive a greater share of voting quotas. The EU now has till 2012 to decide which countries will give up their seats, with the Belgian Presidency proposing that they should be rotated among Member £ States. President Van Rompuy described Europeans' readiness to accept IMF reform as a "major effort in favour of emerging countries" in an attempt to strengthen global governance. But he also made an appeal to emerging powers by saying that "new rights presuppose a new sense of duty and of shared responsibility".

From Copenhagen to Cancún

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As the Summit concentrated mainly on the reform of economic governance, there was not much debate on the climate issue. In the end, EU leaders issued a familiar-sounding *communiqué* stressing once again the urgent need to make progress in tackling climate change. The Summit Conclusions state that the Cancún Conference in November/December must deliver a significant intermediate step on the way "towards a global comprehensive legally binding framework".

However, the chances of a new global climate deal remain slim after the 'Copenhagen disaster' of last December. Since then, there has been a perceptible increase in 'climate fatigue' as political and public attention as well as popular support for the issue have fallen in both the US and Europe. The prospects for a new binding framework will most probably also worsen after the US mid-term elections, as the Republicans, who are likely to dominate one or even both houses of Congress, have firmly positioned themselves against any new legislation on climate change. As chances for a new comprehensive climate deal diminish, the EU has already signalled the Union's willingness to 'at least' agree to a second Kyoto Protocol commitment period.

The EU itself is also heading towards some difficult negotiations, as some Members States – especially in Southern and Eastern Europe – are hesitant about supporting the Commission's desire to increase the EU's emissions reduction target to 30%. The Summit Conclusions merely state that the Union will re-examine the options to move beyond 20% after Cancún.

Another issue where the EU lags behind relates to the Copenhagen commitment of developed countries to provide the developing world financial assistance to adapt to the unavoidable consequences of climate change. As an immediate down-payment, in Copenhagen rich countries promised €21.8bn in 2010-2012, of which €7.2bn would come from the EU. But although almost all EU countries had made spending pledges on fast-track finance by last May, the Commission has not received precise figures and information about the projects Member States will support. In addition, doubts in the developing world have increased as to whether the additional money promised will in the end merely be 'old money' disguised in 'new envelopes'. All this does not strengthen the EU's credibility and its overall position in the next phase of international climate negotiations.

Preparing bilateral summits with the US, Russia, Ukraine, and India

In line with the decisions taken at the September European Council, which was devoted to strategic partnerships, EU leaders discussed the upcoming bilateral summits with the United States, Russia, Ukraine and India.

These debates are part of an ongoing effort to involve the European Council more closely in the EU's foreign policy, aiming to – as President Van Rompuy put it – "underpin the Union's key messages with specific negotiations and trade-offs".

This is a positive development, but it is questionable whether discussions on the second day of a complicated and exhausting Summit will make EU foreign policy more 'strategic'. Indeed, this is probably too much to ask for, as long as national capitals are themselves unable to overcome their own lack of strategic thinking, which is a prerequisite if Europe wants to speak with one voice to 'strategic partners' about complex and sensitive foreign policy issues.

Janis A. Emmanouilidis, Senior Policy Analyst, European Policy Centre