›› POLICY BRIEF
ISSN: 1989-2667

FRIDE
A EUROPEAN
THINK TANK FOR GLOBAL ACTION

Nº 109 - DECEMBER 2011

After the summit: can the cracks be healed?

Giovanni Grevi

›› The European Council meeting on 8 and 9 December 2011 marked a watershed for the European Union (EU). Yet it neither heralded the end of the crisis afflicting the continent nor fleshed out the shape of the new Europe. The leaders of the Euro area showed common resolve to move towards a new fiscal compact and share an unprecedented level of sovereignty. However, the deal fell short of providing adequate solutions to the euro crisis in the short term. Instead, the summit exposed concerns that could infect fundamental aspects of the European integration process. Cool diplomatic heads and steadfast action are now necessary on all sides to heal the cracks that have opened within the very fabric of the EU. In particular, leadership is required to redefine a workable relationship between the UK and members of the fiscal compact; to restate the centrality of common rules and institutions to the cohesion of the Union; and to bridge the gaps of growth and legitimacy that are widened by a focus on austerity alone. Short-term reaction to the crisis summit has been plentiful and critical; eyes must now be lifted to managing the medium-term fall-out.

HIGHLIGHTS

- There is a need to prevent the split with the UK on the Euro from degenerating into one on the Union.
- All EU member states, chiefly the largest, should commit to work through the common institutional system, or else their influence will be contested.
- The focus on austerity widens the gap of political legitimacy within the Union. A counter-cyclical narrative needs to address issues of growth and cohesion.

THE EUROPEAN REARGUARD

The British veto on stronger fiscal and economic rules for the Eurozone being introduced in the existing treaties has triggered agreement by the other 26 members states to negotiate a separate international treaty to achieve a ‘stronger economic union’. Most observers have concluded that the major spat between David Cameron and his European colleagues, chiefly Nicolas Sarkozy and Angela Merkel, spells a two-speed Europe. Not quite.

For one, as Commission President Barroso put it, this is less an agreement at '17 plus', with two distinct groups of countries taking different paths, than a deal at '27 minus'. For another, while overshadowed by the British veto, there is no shortage of political differences within the Eurozone and among the nine countries that have committed to the fiscal compact. Conversely, the split concerns economic governance and not EU policies across the board, notably foreign and security policy – at least for now. If as many as 23 to 26 countries did join the new treaty, as looks possible, the political reality would not be an avant-garde pressing ahead of the bulk of EU member states but a tiny rearguard lagging behind most others. For the UK, this would be a strategic failure. For the rest of Europe, it is important that such a failure does not cause the drift of an important EU country away from the Union.

David Cameron vetoed an EU treaty amendment since he failed to secure safeguards for Britain's financial services. Openly threatening or wielding vetoes in the EU context is itself a symptom of diplomatic weakness. Successful EU decision-making involves reaching compromises that reduce any subsequent need for posturing and vetoing. The UK drew a Maginot line in the explicit defence of the interests of the City of London at the same time as the air squadrons of the rest of Europe were flying over it, rushing to rescue the euro. This is all the more perplexing given that over 50 per cent of British trade is with the EU itself and that sovereign defaults and severe economic recession within the Eurozone would hit the UK very hard.

Prime Minister Cameron put forward two main motives to justify his stance: the UK wants to preserve its sovereignty at a time when others have decided to pool theirs, and it remains squarely at the core of what really matters, namely the single market. Arguably, the UK has exercised its sovereign right to become 'less relevant' in presenting and defending its own vision of the single market. Important debates on market issues and level-playing fields will likely be held among those countries that have decided to abide by common rules on their basic economic policies. Decisions will continue to be taken in relevant Council configurations at EU-27 level by qualified majority voting.

It would be wise for the UK's partners in the EU to prevent the split over the euro from turning into a split over the Union. Bureaucratic hurdles between various policies may be hard to surmount but differences in one important domain can easily spill over and pollute relations. One or two countries cannot hold the rest of the Union hostage to their reservations on further integration. But now that the emotional post-summit weekend is over, it is important that leading EU countries such as Germany and France, as well as others, discretely re-engage the UK and openly re-assert the relevance of the EU framework at 27 (soon 28). If the UK doubts its place in Europe, the choice of drifting further away from it should be its own and in no way instigated by its main continental partners. In fact, averting such a choice will be a test of the latter's leadership.

THE EUROPEAN ETIQUETTE

Exceptional times may call for exceptional measures and methods. When push comes to shove, those with the clout and resources to make a real difference in addressing common threats call the shots. The EU cannot escape some basic realities of international politics but it was set up to replace the rules of power with the power of rules. Since the outbreak of the Greek debt crisis 20 months ago, Europe has witnessed a collective failure of leadership, paralleled by the predominant influence of Germany and France over the Union. The leadership crisis is not just about the wisdom of individual decisions (or lack thereof) to curb financial contagion and re-establish the confidence of the markets. It is about the waning sense of cohesion within the Union, which budget rules cannot substitute for, and neglect of the Community method.

It is interesting that so much intellectual and political investment has been made in the last ten years or more only to sabotage the one way of making decisions that has ever worked in the EU context. At its core, the Community method simply consists of decision-making by majority voting on the basis of an initiative taken by common institutions in the common interest. Member states are fully involved both in setting the agenda, not least via the European Council, and in negotiating and approving specific decisions, together with the directly elected European Parliament. While the Community method can be adjusted to fit distinctive policy areas, the clumsy management of the European debt crisis has been driven by the assertion of distinctive national interests and narratives. Somewhat paradoxically, it is the UK, which has consistently called for an inter-governmental Europe where the big three run the show, that complains today about the alleged Franco-German diktat. Such is the state of play under the loosely defined 'Union' method articulated by Chancellor Merkel in Bruges in 2010.

The summit exposed concerns that could infect fundamental aspects of the European integration process

Large countries will always play a pivotal role within and outside the EU, whether in taking initiatives or in building coalitions. A context of crisis may amplify this pre-eminence, not least because others lack the assets (such as financial or military capabilities) needed to back their voice. But pre-eminence, notably within the EU, will only prove sustainable if rooted in law and practiced through a method that reflects a genuine *community* of purpose and destiny. This is all the more so when it comes to adopting measures that compress national sovereignty, devitalise to some extent national parliaments and entail painful sacrifices for citizens in many countries. The European *etiquette* is a question of political substance and not empty formalism. Central to it is respect for and, when necessary, the empowering of common institutions.

The statement by the euro area heads of state and government envisages an important role for the Commission and the European Court of Justice in the implementation of the new fiscal compact. The Commission will oversee the excessive deficit procedure, scrutinise the budgetary plans of the member states and trigger quasi-automatic sanctions (a qualified majority of member states can oppose them) in the case of a breach of the 3 per cent deficit ceiling. Member states will introduce the principle of budgetary balance at constitutional level and in relevant legislation, while the European Court of Justice will monitor its actual transposition. In other words, the members of the Eurozone and other countries seem determined to put in practice an upgraded Stability and Growth Pact years after having agreed, and happily ignored, the original version. The long-term question is whether the Commission will actually gain the authority to enforce the new rules regardless of who is in breach. Another key factor is how it will be able to operate within the framework of the envisaged fiscal compact, which will depend on how exactly the latter is set up and how comprehensive it will be. The short-term question is whether the Eurozone will last long enough to see the fiscal compact implemented.

BRIDGING THE GAPS

Much speculation about 'sequencing' has surrounded the historic agreement on the fiscal union. Such a deal, it was argued and hoped, would unlock stronger intervention by the European Central Bank (ECB) and perhaps the International Monetary Fund (IMF) in support of countries at risk, notably Italy and Spain. After all, in 2012 Eurozone governments need to service over a trillion euros of debt, including €200bn for France, €170bn for Italy and €68bn for Spain between December and April. However, decisions on the so-called 'stabilisation tools' to tame the markets in the short-term have

been much less ambitious than plans for the fiscal union over the long-term. It remains unclear whether the firewall designed to prevent defaults will be strong enough to carry the Eurozone through this perilous transition. Markets seem underwhelmed. Uncertainty looms large at both the economic and the political level.

On the economic side, positive decisions include the launch of the European Stability Mechanism (ESM) expected in July 2012, which would run in parallel to the European Financial Stability Facility (EFSF) until mid-2013. The involvement of the private sector in future debt restructurings will follow IMF practices, which is designed to assuage market fears following the 50 per cent haircut imposed on banks and other institutions on Greek debt. Moreover, the governance of the ESM has been improved by introducing an emergency procedure requiring not unanimity but an 85 per cent qualified majority to release funds on a recommendation from the Commission and the ECB. For their part, EU member states have agreed to 'consider' providing the IMF with up to €200bn in additional resources via bilateral loans, which could in turn be mobilised to rescue vulnerable EU countries. This is a necessary move which EU leaders hope will encourage other key actors, notably emerging economies, to contribute to the firewall.

However, the combined firepower of the EFSF and of the ESM is yet to be defined and will be the subject of a further assessment in March. Besides, while ECB President Mario Draghi has welcomed the fiscal compact, it seems unlikely that the central bank will fundamentally shift its approach and enter unchartered legal waters by directly purchasing vast amounts of government debt. No mention was made at the summit of Eurobonds or other forms of collective debt issuing, though the issue is reportedly not off the agenda at the insistence of France and Italy among others.

The main problem is that the crisis has been framed mainly as a budgetary one, which many economists believe it is not, and the summit statement has put the final seal on this partial interpretation. The fiscal medicine may indeed prevent relapses in the deficit and debt diseases but fails to address other infections such as diverging levels of competitiveness and imbalances in trade and capital flows. Substantial references to re-launching growth and competitiveness are strikingly absent in the euro area leaders' statement, except for a quick mention in the introduction. Many EU member states face recession in 2012 and market confidence will not be won back without solid growth prospects. Growth requires credit flows, which have run dry since European banks are loaded with sovereign bonds and need to recapitalise. The ECB intervened last week providing unlimited liquidity on favourable terms to European banks and cutting interest rates to 1 per cent. Growth is also a condition for jobs, which are a priority if Europe is to be seen not just as the source of stifling constraints but also as the engine of renewed prosperity.

The fundamental problem is, of course, political. How much traction can European leaders gain in pursuing a top-down fiscal union while cohesion within and between European societies is cracking from the bottom up? An even more important gap than the one between short-and long-term measures is that between what is considered necessary by leaders and officials and what is perceived as legitimate by the people. Danger lies in putting the institutional cart before the democratic horse. All the more so if the cart is laden with austerity measures only. It is likely to prove a red banner for the populist bull. The ratification of the fiscal compact and the introduction of the balanced budget rule in national constitutions face arduous parliamentary debates and possibly a referendum in Ireland, at a time when the economy is slowing down and welfare is being slashed. Years of distorting caricatures setting selfish northerners against lazy southerners have undermined the sense of shared purpose that is essential to overcome the crisis. Europe needs a counter-cyclical narrative that speaks to the concerns of the people and bridges the gap between arcane budget rules and the

demand of equitable burden-sharing within and between countries. National and EU leaders will be responsible for providing one.

CONCLUSION

The agreement of the vast majority of EU member states to move towards a fiscal and economic union marks a new departure for European integration and signals considerable common resolve. Whether this is the end of the beginning or the beginning of the end will depend not only on the markets but also on collective leadership at three levels.

First, the split with the UK over the euro must not become a split over the Union. That would be in nobody's interest and would set a dangerous precedent. Yet those member states that wish to integrate further must be allowed to do so. Mending the rift should be a priority for all parties.

Second, if large countries carry large influence, they must exercise this within the common institutional framework and not on the basis of exclusive consultations. Having achieved an important milestone, Germany and France should engage in a form of strategic reassurance towards their fellow member states, large and small. They should restate their intention to operate through and not around the system. Otherwise, the transmission belt from the Franco-German engine to the EU's wheels will stick, threatening to end the European journey.

Third, leadership is required to bridge the gap between ambitious long-term plans and deficient short-term measures needed to support vulnerable countries, stop financial contagion, channel liquidity to the economy and re-launch growth. Equally important, national and EU leaders must articulate a narrative that sets budgetary rules and concurrent sacrifices within the broader perspective of a community of values and shared destiny. Austerity will not work without a sense of belonging to, and ownership of, a common project.

Giovanni Grevi is a senior researcher and research coordinator at FRIDE

e-mail:fride@fride.org
www.fride.org