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The EU27 economic indicators for the end of 2012 therefore painted a bleak picture: soaring unemployment (10.8 per cent of the active population), a slip back into recession (-0.3 per cent GDP) and a growing public debt ratio (85 per cent). The scenario for the Eurozone was worse and even more so for countries such as Italy, Portugal and Spain. This drama, furthermore, was unfolding in a rather fragile international context; nonetheless, since the overall global situation was generally positive, we cannot lay the blame there.

The inference to be drawn is that the one-dimensional policy of austerity and deep cuts in welfare spending decreed by the EU, combined with the avoidance of any stimulus measure, has proved to be an outright failure. No signs on the horizon encourage any optimism that the austerity policy, if continued, will improve matters. This is hardly surprising, as to a large extent, this very policy is the root cause of the negative figures.

THE STATE OF THE EUROPEAN UNION 2012



THE STATE OF THE EUROPEAN UNION

The failure of austerity



2012

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The State of the European Union

The Failure of Austerity

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The Failure of Austerity

Director:

Diego López Garrido

Co-directors:

Nicolás Sartorius and Lothar Witte

Coordinators:

José Luis Escario, Vicente Palacio and María Pallares

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Presentation

This Report on the State of the European Union analyses a decisive year in the project for Europe. In the midst of a tough economic crisis the very viability of the euro has come in question and thus the very existence of the European Union. At the same time, adjustment policies have impaired social conditions and have inspired a growing distrust of institutions among European citizens.

In this report, produced by Fundación Alternativas and Friedrich-Ebert-Stiftung, we present the results of a rigorous analysis of key European Union events of 2012, performed, in a critical and constructive spirit, by a group of leading experts. The health of the European Union is scrutinised and a series of proposals and recommendations are made, aimed at informing decision-making by political, social and economic stakeholders. The report will also, we hope, make a key contribution to the debate on the future of the European Union.

In these pages, the reader will encounter an accurate description of events in the European Union in 2012 and an assessment of their impact on citizens' lives. Carlos Closa analyses institutional changes, the tensions between intergovernmentalism and federalism and the roles of the European Council, Commission and Parliament – in a word, he assesses whether member states or European Commission/Parliament roles have expanded. Enrique Ayala addresses the issue of democratic legitimacy, the political impact of the crisis on this legitimacy, the risks to democracy and the degree of citizen interest in or indifference to the European project – in short, he analyses the democratic health of the European Union. Klaus Busch discusses austerity policies and the European social model, dissecting how far and in what direction cuts have affected the welfare state.

The section on economic crisis and debt contains four chapters. Björn Hacker discusses economic governance, whether the instruments launched in 2012 have been sufficient, whether economic policy directions have been right or wrong, Germany's role and the socioeconomic impact of policies in a number of countries and in the European Union as a whole. Manuel de la Rocha and Miguel Angel García Vázquez discuss current economic policies, the austerity/growth binomial and possible solutions to the crisis, while highlighting the effects of the recession in Europe.

Domènec Ruiz Devesa focuses on the decisive role played by the European Central Bank during the crisis, the scope of its various decisions and the place it should occupy in the future. Finally, Angel Berges and Emilio Ontiveros analyse the European financial system as a whole, the origins and unfolding of the crisis and successive reforms and their results.

The section on European competitiveness also contains four chapters. Regino Moranchel addresses the crucial issue of European R+D+I policies and initiatives, the relative position of the European Union in relation to other economic blocks and European strengths and weaknesses in regard to the new technologies. Raul Compés and J.M. García Álvarez-Coque address the current situation with regard to the Common Agricultural Policy with special reference to measures adopted in 2012 and to a future ruled by new financial perspectives. Teresa Ribera squarely tackles European environmental policy and climate change, which is of crucial importance to globalisation and the future of humanity, and not an area in which the European Union has had its best year. Finally, Pedro Moraleda considers an issue crucial for the European Union, energy, bearing in mind its energy dependence and its lack of a single energy market.

The section on foreign policy, defence and security contains four further chapters. Vicente Palacio and Francisco Aldecoa analyse European foreign policy, the difficulty of adopting a common position on certain issues, progress in some areas and setbacks in others and the evolution of the European External Action Service. Jordi Marsal discusses the impact of the economic crisis on security and defence policies, focusing on budgets, technology, capacity and operations abroad. Niels Annen focuses on EU relations with major global players such as the USA, China, India, Russia and Brazil, decisive for the future of humanity as a whole. Finally, Carlos Carnero and José Manuel Albares assess the all-important neighbourhood relationships with eastern European countries and with Mediterranean countries in the post-Arab Spring scenario.

The report concludes with a series of recommendations and proposals that summarise the analyses of the individual authors and their opinions on what can be done to ensure that, apart from emerging economically and socially strengthened from this crisis, the democratic legitimacy of the European Union, so essential to restoring confidence and promoting citizenship, is enhanced.

With this report, which is simultaneously published in English and in Spanish, our two foundations, with their clear European focus, enter a new phase in their long-standing cooperation on European issues. We hope that this partnership between a Spanish and a German foundation contributes to strengthening the European debate beyond the borders of

the member states – a debate that we believe to be now more necessary than ever.

In conclusion, it merely remains for us to thank, on behalf of the two foundations, the individual authors for their efforts and for the high levels of excellence evident in their contributions; the report director, Diego López Garrido, for his introduction and also for his work in relation to conception, coordination and supervision; the members of the European Affairs Council of the Fundación Alternativas for leading the production of this report; and José Luis Escario and María Pallares, who acted as report coordinators. Last but not least, we also thank the Secretary of State for European Affairs for assistance provided through the »Hablamos de Europa« programme.

We sincerely hope that this report will prove to be a useful instrument for all those who strive to build a more democratic, just and sustainable European Union.

Nicolás Sartorius

*Executive Vice-President
Fundación Alternativas*

Lothar Witte

*Delegate to Spain
Friedrich-Ebert-Stiftung*

Introduction: Twelve Months of Economic Despair

Diego López Garrido

No good omens marked the beginning of 2012. A week after the European Central Bank (ECB) lent 500 billion euros to 523 Eurozone banks (21 December 2011), commercial banks deposited 411.813 billion euros with the ECB; this amounted to some 146 billion euros more than before the ECB auction. The banks chose to hold onto funds raised at auction, for which they paid interest at 1 per cent, rather than lend it to each other, purchase debt or extend credit. The lack of confidence in the soundness of the European financial system was evident. The euro fell to 1.30 against the US dollar.

Olivier Blanchard, chief economist of the International Monetary Fund (IMF), stated that breakup of the Eurozone was a real possibility and that credible fiscal consolidation with sufficient liquidity provision would be required to avoid disequilibria. IMF managing director Christine Lagarde called on European leaders to act as one and to set out a detailed timetable of measures aimed at tackling the debt crisis. The Eurozone needed to roll over 1,269.444 billion euros during 2012. IMF forecasts for Eurozone growth during 2012 were bleak.

This is how 2012 dawned. And none of its 12 months engendered any more optimistic signs regarding the economic situation. As for the political situation, the great weaknesses of the EU's dysfunctional institutional architecture became only too obvious, as the contents of this Report will make patently clear.

It must be conceded, however, that progress towards the construction of an »economic governance« structure in the EU has been somewhat

more promising. In early 2012, on 30 January to be precise, the European Council — the EU jack-of-all-trades since the Lisbon Treaty — approved the Treaty on Stability, Coordination and Governance (TSCG) with the support of all the EU member states, except the eurosceptic United Kingdom and Czech Republic. According to the TSCG, budget deficits may not exceed 0.5 per cent of GDP and member states must assume this obligation by enacting the corresponding primary national legislation.

At the same European Council meeting, the treaty establishing the European Stability Mechanism (ESM) was agreed. The ESM, intended to combine with the older European Financial Stability Fund (EFSF), has a lending capacity of 700 billion euros. This is the »firewall« clamoured for by the IMF.

Around the same time, an initiative was launched aimed at relieving pressure on the battered public finances of the EU. This was the long-awaited international financial transactions tax, a progressive measure that would combat the destabilising effects of financial speculation. From the perspective of Germany, which dominated the European Council meetings of 2012, this Tobin tax was a concession, given Germany's fierce opposition to eurobonds. Angela Merkel emphatically voiced this opposition several times during 2012, while insisting on a prior transfer of sovereignty to the EU to restore credibility in the European project.

These undoubted advances on the economic governance front were not accompanied by any significant progress with a longed-for countercyclical economic policy. The EU budged not an inch from its monotone recipe calling for cuts and austerity, which, as far as EU citizens are concerned, brought no minimally positive or reassuring results.

The six-point plan to address the euro crisis, jointly presented to the European Council in early 2012 by »Merkozy« – as journalists liked to call the duo composed of the German and French leaders – lacked coherence. It was simply too vague to be of any real use in tackling the slowdown in growth experienced from late 2011. The European Commission forecast a recession for the first half of 2012 and a return to moderate growth for the second half of 2012. The IMF, meanwhile, although painting particularly negative scenarios for Greece, Italy, Portugal and Spain, insisted that the Eurozone would not emerge from recession until 2013. The IMF was proven right, despite ECB efforts to extricate the European economy from the mire it found itself in by trying to implement a monetary policy that would contribute to growth. It failed, mainly because of the narrowness of the mandate granted it by the EU Treaties.

In February, the ECB extended more flexible credit lines to banks in seven countries (Austria, Cyprus, France, Ireland, Italy, Portugal and Spain),

while allowing their central banks to relax collateral criteria. It set the official interest rate at between 1 per cent and 0.75 per cent to unclog lending. It also openly stated that a bond purchase programme to help troubled countries was open. Mario Draghi, resisting pressure from the German Bundesbank to raise interest rates and withdraw such support, managed to keep this »liquidity bar« for banks open.

On 9 June, the Eurogroup approved a financial lifeline for Spain, of up to 100 billion euros, so that it could recapitalise its banks. Demanded in return were structural reforms, particularly of the financial system and the labour market. The latter in the end merely contributed to push up Spain's lamentable unemployment rate even further, which is still growing in 2013. Spanish businesses failed to benefit, as credit remained tight. Monetary policy has its limits, as Mario Draghi pointed out repeatedly; bank recapitalisation is also limited in its effectiveness when banks use the money, not to provide credit to businesses, but to repair their balance sheets. The ferocious austerity measures, in the form, mainly, of spending cuts applied over a very short time period, evidently choked off Eurozone economic recovery and were counterproductive in terms of improving the employment scenario.

A timid stimulus package in the EU failed to offset the contractionary effects of the austerity policy. One example was the decision of the European Council of 28 and 29 June to launch an ambitious-sounding Compact for Growth and Jobs, aimed at mobilising 120 billion euros in immediate measures; however, no »new« money was earmarked for this programme. By mid-2012 in the Eurozone, overall unemployment had climbed to over 11 per cent, while youth unemployment had reached 22.6 per cent; these figures, however, masked great differences throughout the EU, as over 50 per cent of young people aged under 25 years in Spain and Greece were unemployed.

The north/south divide in the Eurozone reached its zenith in 2012. The IMF warned of the risk of deflation in its annual report on the Eurozone. According to Eurostat, the Eurozone economy contracted -0.2 per cent in the second quarter of 2012; furthermore, a third of the 17 eurozone countries were in recession. The decline in economic activity occurred despite moderate growth in Austria, Germany, the Netherlands and Sweden. Economies shrunk in Belgium, Finland (surprisingly), Italy, Spain, and, outside the eurozone, the United Kingdom.

The situation was extremely worrying in the summer of 2012, with spreads for Spain and Italy sky high. This was when Mario Draghi made his widely publicised declaration that »the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.« He also

commented that markets were underestimating progress being made towards a European banking and economic union. Draghi's announcement became reality in September. The Governing Council of the ECB announced secondary market purchases of the sovereign debt of troubled countries through a new outright monetary transaction (OMT) programme that would replace the previous asset purchase programme. The main OMT conditions were that the recipient country would formally request assistance from the ESM, debt maturity would be between one and three years, bond purchases would be sterilised and the minimum credit rating requirement for state-guaranteed assets would be eliminated.

This ECB decision had the effect of steadying the markets and moderately decreasing risk premia. It also put a brake on capital flight towards the EU core countries, estimated to amount to 296 billion euros and 235 billion euros for Spain and Italy, respectively, for the period between June 2011 and June 2012.

Despite these measures, the issues that most directly affected citizens — growth and jobs — continued to mark a dismal trend in the second half of 2012. Eurozone GDP contracted -0.1 per cent in the third quarter of 2012 compared to the previous quarter, for a year-on-year change of -0.6 per cent. For the EU27 as a whole, the corresponding figures were $+0.1$ per cent and -0.4 per cent.

The European Commission attributed the economic contraction to a deteriorating labour market, private sector indebtedness and fiscal consolidation, occurring in a context of a weakening global economy, as underlined by the OECD in its Economic Outlook for November 2012. The OECD, despite its liberal tradition, criticised ineffective economic policies and recommended easing monetary policy, using the Eurozone and the USA as examples.

The US example is particularly useful in terms of questioning the economic policy dictated from Brussels. In March 2012, US Secretary of the Treasury Timothy Geithner had already warned Europe of the perils of draconian budget cuts, pointing out that it was necessary to carefully calibrate financial support in combination with the pace of fiscal consolidation. He said this just around the same time that the Chairman of the Federal Reserve, Ben Bernanke, requested more incentives for employment. Unlike Draghi, Bernanke has always made it clear that he would act to support growth if the economic situation deteriorated. This explains his policy of exceptionally low interest rates (between 0.25 per cent and 0 per cent), to be maintained until the end of 2014, and his bond purchase programme. In December 2012, the Federal Reserve decided to continue its stimulus package as long as the unemployment rate remained above

6.5 per cent and provided forecasted inflation for one or two years did not exceed 2.5 per cent. It also launched a long-term bond buying programme, based on purchases of 45 billion US dollars a month to be added to the 40 billion US dollars in monthly mortgage asset purchases.

Thus, despite the fiscal cliff and the Congress blockade, the economic situation in the USA looked more promising than in the EU, which was facing numerous obstacles in triggering the recovery of an economy deeply damaged by the crisis. In January 2013, US unemployment – at 7.9 per cent – was at the same level as in September 2012.

In the EU, results all round for 2012 were disappointing: not only was the region in recession, but the unemployment rate was at a totally unacceptable level. The latest Eurostat report on the harmonised unemployment rate available at the time of writing (early 2013) indicated that the EU27 and Eurozone unemployment rates for 2012 were 10.8 per cent and 11.9 per cent, respectively, and 23.6 per cent and 24.2 per cent, respectively, for those under 25 years of age. In 2011, the corresponding figures for overall unemployment were 10 per cent (EU27) and 10.6 per cent (Eurozone). This is the highest level in the history of the euro. That 2012 was a lost year for employment, therefore, goes without saying.

As for economic growth, the figures were equally grim, as 2012 was a year of recession. Eurozone and EU27 GDP fell by 0.6 per cent and 0.3 per cent, respectively, halting the modest growth seen in 2010 (1.9 per cent for the Eurozone and 2 per cent for the EU27) and 2011 (1.4 per cent for the Eurozone and 1.5 per cent for the EU27).

Finally, the picture in relation to accumulated public debt was also disheartening. By the end of the third quarter of 2012, public debt as a share of GDP in the Eurozone and the EU27 had climbed to 90 per cent and 85 per cent, respectively; in the third quarter of 2011, the same figures were 86.6 per cent and 81.5 per cent, respectively. A total of 22 member states recorded increases in their debt ratio, with the highest increases occurring in Cyprus (17.5 per cent), Ireland (13.4 per cent) and Spain (10.7 per cent).

The EU27 economic indicators for the end of 2012 therefore painted a bleak picture: soaring unemployment (10.8 per cent of the active population), a slip back into recession (–0.3 per cent GDP) and a growing public debt ratio (85 per cent). The scenario for the Eurozone was worse and even more so for countries such as Italy, Portugal and Spain. This drama, furthermore, was unfolding in a rather fragile international context; nonetheless, since the overall global situation was generally positive, we cannot lay the blame there.

The inference to be drawn is that the one-dimensional policy of austerity and deep cuts in welfare spending decreed by the EU, combined with

the avoidance of any stimulus measure, has proved to be an outright failure. No signs on the horizon encourage any optimism that the austerity policy, if continued, will improve matters. This is hardly surprising, as to a large extent, this very policy is the root cause of the negative figures.

In view of the disappointing second half results for 2012, the European Commission forecasted a further contraction of -0.3 per cent GDP for 2013 in the Eurozone and a rise in unemployment to 12.2 per cent. Credit, meanwhile, is still tight and household consumption continues to fall.

All this has only accentuated the substantial differences in growth, incomes and employment between the countries of the EU. The same divide is repeated in public debt financing: Austria, Finland, France, Germany and the Netherlands charge for their debt, whereas Ireland, Italy, Portugal and Spain are paying record interest rates. This explains the steady rise in public debt in the Eurozone in 2012 (except in Greece and Finland), despite fiscal consolidation efforts.

Draghi's declaration before the Spanish Congress of Deputies on 12 February 2013, indicating that the first positive results of adjustment could already be observed, is not, in fact, supported by the evidence. The unexpected economic contraction of the last quarter of 2012 has once again led to a loss of confidence. Any amelioration in the deficit situation or in the financial market means little to citizens, as long as improvements are not reflected in the real economy.

This is an objective overview of a 2012 in which the EU invested all its efforts in trying to respond to one adverse development after another. There was no time to forge ahead in any significant way with issues such as the common foreign and security policy, although, for the first time since 2008, the European Council agreed to discuss European defence. It remains to be seen whether this will happen before the end of 2013.

Nor did key sectoral policies such as agriculture, energy and the environment receive the media attention they merited in 2012, despite interesting developments, as detailed in this Report.

There was, however, some reflection on the institutional architecture, starting with the European Council meeting of June. However, the ambitious proposal of a banking union (with a single supervisor, even if with limited powers), fiscal union and economic union is still at the drawing-board stage, and, as usual, words have not been matched with actions.

This Report not only brings together considered reflections on essential aspects of the State of the Union, but also makes proposals for the future in the form of a list of Recommendations. These include the need to reject austerity as the only economic policy option, a rejection perfectly compatible with the need to be competitive.

We hope that this Report will enable the reader to adopt a position on what is ultimately the only possible horizon for the EU: political union. This issue has several dimensions: the greatly conjectured economic union, representing progress towards identifiable and adroit economic governance; a social dimension, as yet non-existent; and a democratic dimension that reflects the European Parliament's powers in relation, first, to the intergovernmentalism that has emerged particularly forcefully since the onset of the crisis, second, to the European Council as the primary decision-maker and, third, to the inexorable rise of Germany as an EU powerhouse. It is also a matter of some urgency to move onwards in the debate on the reform of the EU Treaties, which, as Jürgen Habermas points out, lack a clear overall perspective.

It should not be overlooked that any advance in political union will force the EU to confront the most important negative repercussion of the crisis in Europe, namely, solidarity between citizens and between states — a solidarity that is singularly lacking in the EU budget agreed for the next seven years. This, in fact, was the last blow delivered to us in 2012.

This same year, nonetheless, witnessed the awakening of the citizens of Europe, mobilised by the welfare state crisis and uncertainties regarding their future. This is the real challenge facing the EU, as its public credibility, and more, will depend on how it weathers the storm, gets the economy back on track and leads the way out of the crisis, while respecting the values of freedom and progress that symbolise the European project.

The European Institutional Architecture

Intergovernmentalism as a Previous Step to ‘Community Method’

Carlos Closa

Labels, categories and ideal types have an essential utility in knowledge: they help us to classify phenomena according to the characteristics that correspond to each and every one of them. Nevertheless, mechanically applying ideal types to empirical data can lead to distortions. This has been the case with the concepts of “intergovernmentalism” and “Community method” that some scholars have used to conceptualise the evolution of the EU during the period of the crisis. It is undeniable that from 2008 through 2012 European governance tilted heavily towards what could be considered intergovernmentalism; for example, joint Franco-German leadership has been known to give way to unilateral German leadership on a number of occasions. However, a closer, more detailed scrutiny of events offers a slightly different, if not necessarily more satisfactory, view of the situation.

This chapter argues that intergovernmentalism has not clearly emerged as the sole institutional model employed to respond to the current crisis. One can also speak of ad hoc mechanisms. Throughout 2012, the EU continued to be mired

in a “decisional” state of emergency that it has not been adequately equipped to deal with since the outbreak of the crisis in 2010–2011. The most characteristic response to this situation has been the creation of on-the-spot rules of the game intended to address critical problems as they arose by means of an “emergency constitutionalism” based on the so-called “Six Pack”, a set of new legislative measures that have underpinned the reform of the Stability and Growth Pact. These pacts have been primarily directed to financial markets and governments; they convey an initial commitment to austerity to the former, while imposing budgetary “straightjackets” on the latter. It might be added that the sensibilities of the German electorate appeared to have weighed heavily on minds of European authorities when these decisions were made. At the same time, the European Council has occupied a central locus of decision-making and has parlayed its functions into a new institution that, strictly speaking, is not an EU institution – the Euro Summit – that has given a greater prominence to heads of state and government.

Intergovernmentalism: Political and Institutional Perspectives

Analyses that signal a shift toward intergovernmentalism within the EU rest on one of two basic arguments. The first postulates that Franco-German leadership has often assumed the role of a directorate that has imposed its wishes on other states, the most radical example being its advocacy of technocratic governments in Italy and Greece at the end of 2011. Another, more extreme version, goes so far as to claim that the Union functions under the purely unilateral leadership of Germany. The second stresses what some analysts see as the asphyxiating hegemony of the European Council in decision-making and its role in the emergence of new structures (Euro summits) that have given heads of state and government a monopoly on power. There is a clear, connecting thread between the two arguments that provokes the strongest expressions of distrust and criticism: that institutional intergovernmentalism could become an excellent vehicle for furthering bilateral or unilateral interests. The following analysis does not question the veracity of the facts put forward in these opposing arguments, but rather seeks to offer a more constructive interpretation that serves to dispel the perception of a shift towards intergovernmentalism within the EU.

Franco-German... or German Leadership

Franco-German leadership is not a new development in the process of European integration; on the contrary, it could be considered to have been a constant from the very beginning. What is new is the assertion that it constitutes a form of intergovernmentalism, a claim that is justified by statements made by the leaders of these two

countries. For example, in a frequently cited address delivered at the College of Europe in Bruges in November 2010, Angela Merkel defended the approach taken by the Union (as opposed to the “Community method” based on the coordinated action of national governments and solidarity between member states). Sarkozy also expressed his clear preference for the intergovernmental method in a speech given in Toulon on 1 December 2011. According to him, heads of state and government have assumed greater responsibilities because they alone have the democratic legitimacy that allows them to take decisions. Therefore, given Europe’s need to make strategic political decisions, the path towards European integration must be forged through intergovernmental relations.

There is no doubt that the Merkel–Sarkozy alliance and its predilection for summit statesmanship set the style for EU management through 2010 and 2011. However, in the wake of François Hollande’s victory in the 2012 French presidential elections, marked differences in the perspectives of the French and German governments on a range of issues has substantially changed the political landscape. During his presidential campaign, Hollande was explicit about his objections to the Treaty on Stability, Coordination and Governance (TSCG) to the point of threatening non-ratification. Once elected, he demanded that the EU (with the full backing of Germany) develop a growth pact to complement the TSCG. In response, in June 2012 the Council approved the Compact for Growth and Jobs, which mobilised 120 billion euros, a great part of that sum to come from funds recycled from other programmes. Furthermore, Hollande has continued to articulate a discourse that has differed from Germany’s positions on several other points and which have more closely reflected the viewpoints of

southern EU countries. For example, he formulated a proposal for integration that linked steps toward integration to greater levels of fiscal solidarity. At the European Council meeting held in October 2012, Hollande reiterated this perspective, expressing his preference for placing a higher priority on the creation of a European Banking Union (EBU) – especially important in the case of Spain – than rapid progress on fiscal integration. In conclusion, although the Franco-German alliance has waned to some degree, this has not translated into a higher profile for proposals put forward by the French government.

The weakening of the Franco-German axis has put unilateral German leadership centre-stage and permitted German preferences to shape the EU agenda. In a February appearance at the Neues Museum in Berlin, Angela Merkel “signalled” future reforms, calling for a political union to complement the Economic and Monetary Union (EMU). These statements made in Berlin most likely pre-dated work on this topic undertaken by the Van Rompuy Task Force and the Future of Europe Group (see below). As a case in point, in her address before the European Parliament in November 2012, Merkel once again anticipated the ideas – and even the structure – of the report “Towards a Genuine Economic and Monetary Union” issued by Van Rompuy on 5 December 2012. In her speech to the European Parliament, Merkel made specific reference to the same four pillars of the EMU that form the core of Van Rompuy’s vision for the future: the integration of European financial markets (European Banking Union), fiscal integration (which implies oversight of national budgets), integration of economic policies (which implies more EU-level oversight of national policymaking) and democracy issues. The German government has subsequently clung to

its posture and Merkel has rejected the idea of a union involving cash transfers, setting her sights on a fiscal union, which from a German perspective should be based on the budget oversight model introduced through the TSCG. The German government, on the other hand, has come out in support of local and regional German banks, which successfully lobbied against the unified supervision of entire financial systems (the very essence of banking union) and pushed for a more limited oversight applicable only banks considered to be “systemically relevant”.

The weakening of the Franco-German alliance has had another, lesser consequence: the emergence of a stronger multilateralism, if only in a programmatic sense. One expression of this is the Future of Europe Group, founded in June 2012 by 11 states, of which only two – Denmark and Poland – are not part of the monetary union. In September 2012 this group presented a report that may well be the most ambitious of all the documents issued to date on EU reform, although due to its ad hoc nature, it is not expected to play a significant role as this process advances. In summary, Franco-German leadership, which has been a constant in the process of European integration, progressively devolved into a clearly unilateral German leadership during 2012.

The European Council and Its Neighbourhood: The EC President and Euro Summits

Since the beginning of the current crisis, the European Council has played a key role in the EU’s decision-making process. According to Rompuy, this has occurred because, in times of crisis, “institutions built on attributed competences” reach their limitations and navigating uncharted

territory calls for new rules. As its configuration makes the European Council the most suitable of all EU institutions to assume these competences, the end result has been an increase in the number of instances in which European heads of state and government have sat down together and made decisions. As was the case in 2010 and 2011, the European Council met six times in 2012. In comparison, four Euro Summits were held during the same period. Economic governance of the Eurozone has been a longstanding French ambition, but the prospect of a Euro Summit provoked furious opposition during the Convention and the proposal was dropped. Up until 2010, Merkel also resisted the idea of convening Euro Summits. Since that time, Merkel and other leaders have not only accepted the idea, but have also institutionalised the summit since the TSCG's provisions on governance have formally established periodic meetings of this organ.

The appointment of Van Rompuy as the European Council's first full-time president coincided with the current crisis, in which he became a key player in the eyes of government leaders and heads of state. Van Rompuy has been accused of favouring stances taken by the French and the Germans, but the outcome of events has demonstrated his prodigious ability to propose measures and reforms that can be agreed upon by all parties. The report on the future of the EU, prepared in close collaboration with the President of the Commission, the Eurogroup and the ECB, is clear proof that his consensus-building approach is key to achieving the support of a European Council in which member states are wary of any reform that might enhance the powers of the EU. His pivotal position was made manifest by his ad hoc presidency of several Euro summits until his appointment was formalised in March 2012. This position has

inevitably been institutionalised through the TSCG.

The increased power of the European Council should not be interpreted automatically as a reinforcement of intergovernmentalism. If a shift toward intergovernmentalism has, indeed, occurred, it has been at the expense of the Council of Ministers. On one hand, since the Treaty of Lisbon came into effect, EU ministers of foreign affairs have not formed part of the European Council, and consequently their coordinating functions are no longer being carried out at the highest level of government. The Future of Europe Group report calls for the restoration of the General Affairs Council's role in coordination. On the other hand, the reduction of the Council's role also affects the work that finance ministers carry out in the context of ECOFIN since the Eurogroup would greatly restrict their manoeuvrability. In turn, the Eurogroup has also seen its role reduced due to the urgency surrounding the Euro Summit meetings. The only area of the Council that has undergone expansion pertains to the European Stability Mechanism (ESM), which has created a board of governors whose voting members are all finance ministers of Eurozone countries. A unanimous vote is required to grant financial assistance to a member ESM country; however, a qualified 85 per cent majority can make such decisions in situations of exceptional urgency. According to the weighting of votes, which is based on the number of shares of capital stock allocated to each country, only Germany, France and Italy have the right of veto. In summary, although one may speak of an expansion of intergovernmentalism within the European Council, this has not been true in the case of the Council of Ministers.

The Creation of Parallel Legal and Institutional Structures through Treaties

One of the motives for concern about a possible EU bias in favour of intergovernmentalism is related to the creation of *prima facie* legal and institutional structures that, strictly speaking, are not part of the legal framework of the European Union. Faced with the need to come up with emergency solutions to the financial crisis, states that have adopted the euro as their currency have negotiated two international treaties (the TSCG and the ESM) that established legal and institutional structures that run parallel to those of the Union. In anticipation of these treaties, Eurozone states created the European Financial Stability Facility (EFSF), an amorphous instrument constituted as a private, limited liability company headquartered in Luxembourg. Previous to the formal negotiations on the TSCG and the ESM, all EU states agreed in 2011 on the amendment to Article 136 of the TFEU. Revision proceeded through the simplified revision procedure provided for in Article 48(6) of the Treaty on the European Union and was followed by a formal decision on the part of the European Council in March 2011.

National governments negotiated the EFSF, the TSCG and the ESM under "constitutional emergency" conditions that obviated the need to follow standard EU procedures, which call for a convention of representatives of both the European and national parliaments, representatives of individual governments and the Commission. Although the representativity and legitimacy of the Convention may be open to criticism in absolute terms, in relative terms it is the most democratic revision mechanism contemplated in the treaties. In all three cases under consideration here, there were motives for avoiding a convention: the limited scope of the

reform under consideration and the fact that it would not grant new powers to the EU explain the simplified procedure used to amend Article 136; the United Kingdom's refusal to go along with the changes necessary to situate negotiations within the framework of the European Union in the case of the TSCG (although this in itself need not have impeded the use of a more robust democratic method); and the fact that the treaty would only involve Eurozone states provided an argument for not following normal procedures during the negotiation of the ESM. These treaties were negotiated with a speed seldom seen in EU affairs and a corresponding absence of publicity and debate, apart from a few notable exceptions that included the convenient leaking of the five draft versions of TSCG to the press. The TSCG and the ESM were also ratified more quickly than would normally be the case due to the waiver of the requisite of unanimity: the former only required ratification by 12 of the 17 Eurozone states and the latter stipulated ratification by the states that controlled 90 per cent of the capital commitments made (which is to say the seven largest contributors).

The fund established by the ESM depends on contributions provided by member states that come directly from their national budgets; it does not pertain to the EU. Because of this, creating an independent, international organisation under international public law that ran parallel to the structure of the EU was not an "unnatural" step. Notwithstanding this separation, as we shall see, several EU institutions play important roles in the ESM. The distribution of the ESM fund's capital is proportional to the weight of each member state's economy. The monetary value of contributions made to the ESM and the character of the organisation were the focus of a 12 September ruling handed down by Germany's Federal Constitutional

Court, which argued that the liabilities assumed through the ratification of the ESM treaty did not contravene the Basic Law of the Federal Republic of Germany. However, the court did impose conditions; for example, that the ceiling for German contributions must coincide with those established in the relevant annex to the treaty and that the said limit could not be exceeded without the express approval of the German representative to the ESM. It also stipulated that a disposition contained in the treaty regarding the confidentiality of documents and professional secrecy and immunity could not in any manner inhibit the flow of comprehensive information to the German Parliament. Less attention has been paid to the rest of this statement, which concerns the temporary intervention of the ECB in international bond markets, a pending point on which the German Federal Constitutional Court has yet to rule and could consider to be a violation of the German Constitution.

The Fiscal Pact – as the TSCG has popularly come to be known, although it is only one of four sections contained in the treaty as a whole – has been framed as a treaty under international law and as such, it broadens intergovernmental options. While it does not imply the creation of a new and differentiated international organisation, it serves to regulate commitments made by signatory states that EU institutions support. In principle, Van Rompuy considered two possible options: amending the Treaty of the Functioning of the European Union, or, as an alternative, making use of strengthened, already existing cooperation mechanisms. However, opposition mounted by the United Kingdom ruled out the first option, together with German opinion that existing mechanisms did not require sufficient commitment to adhere to the “golden rule” of budget discipline and the concept of “automat-

ic consequences” (debt brakes) from the governments of Eurozone states. Once negotiations were undertaken, they were concluded in record time: the first meeting took place just before the 2011 Christmas holiday and the treaty was signed at the 30 January 2012 EU Summit meeting.

The initial version proposed by the German government would have excessively limited the constitutional autonomy of the states that are party to the pact, in that it would have called upon them to entrust the verification of compliance to their national constitutional courts according to new common criteria that would need to be introduced into each state’s constitutions. However, to avoid the eventuality of Ireland and Denmark having to hold a referendum on a constitutional reform necessary to comply with these requirements, the final version was worded to require states to have a constitutional amendment or analogous extra-constitutional law in place.

The reforms introduced by these three treaties vary in terms of the member states that are party to them, their contents and the methods of governance they outline, but they are nevertheless interlinked. The amendment of Article 136 of the TFEU paved the way for the creation of the ESM, whereas ratification of the TFEU is a precondition for access to emergency funding via the ESM. This arrangement establishes a strong link between the promise of aid and fiscal commitment, a condition required to satisfy the concerns of the German government. The ESM will eventually absorb the FESF. Through a disposition attributed to pressures brought to bear by the European Parliament and the Commission, the TSCG should also be absorbed by the TFEU. The European Court of Justice’s ruling on the Pringle case, handed down on 27 November 2012, resolved some uncertainties

regarding the ESM and intergovernmental frameworks in general. On one hand, as it has been established that none of the dispositions contained in EU treaties impede them from doing so, states are free to sign and ratify the ESM, and on the other hand, it has been made clear that an amendment to Article 136 of the TFEU was not required to create the ESM or for it to enter into force. (The mechanism, in fact, did enter into force before the amendment of the article that facilitated its development.)

One unavoidable consequence of the pursuit of reform mechanisms via external treaties and the lifting of unanimity requirements was that it has opened the door for debate on *differentiated integration and a "hard core" Europe*. Both the Van Rompuy Task Force Report and the plan released by the Commission in November 2012 echoed such sentiments, arguing that the Eurozone should be able to carry out swifter and deeper integration than other European states, while simultaneously maintaining an openness towards non-euro members. Furthermore, the Future of Europe Group's report contains the unprecedented proposal that supermajorities of member states and their populations should be able to approve amendments to European treaties that would be binding only for those member states that have ratified them.

The high visibility of these new treaties and the negotiation processes that brought them about should obscure other major reforms that have been carried out using the time-honoured "Community method", which is secondary legislation approved through the European decision-making triangle constituted by the Commission, Council and Parliament. For example, the four regulations that make up the "Six Pack" were approved through ordinary legislative procedure, and Regulation 1177/2011 on

speeding up and clarifying the implementation of the EDP (which strengthened the "punitive" aspects of the pact for Eurozone member states and established a sanctions mechanism and method for calculating sanctions) and the Directive were both drafted through consultation between the Council and the European Parliament. It is common knowledge that the bulk of the measures contained in the Six Pack anticipate those contained in the TSCG. Another set of regulations, jointly referred to as the "Two Pack" and directed specifically towards states receiving financial assistance, are currently pending approval. Both of these regulations are being developed through ordinary legislative procedures. On a final note, the European Banking Union (EBU) was negotiated on the basis of two directives by ordinary legislative procedure. If the expressed willingness of member states to fuse the operations of the TSCG and the TFEU is added to this equation, the only purely intergovernmental mechanism to remain would be the ESM.

The Growing Role of Agencies and Technical Institutions

Among a range of other factors, the design of institutions takes into account their contribution to the reduction of the transaction costs involved in cooperation between states. However, regardless of type, the model chosen for a given institution is likely to generate unintended consequences. On balance, it must be observed that the new instruments of EU governance have enhanced the roles of functional bodies that have very weak links to democratic and representative bodies (what could be termed "agencification"). Contrary to first impressions, not all of the EU's institutions have been weakened, nor has what

is referred to as the “Community method” been seriously harmed. This is especially evident if one considers the impact of the Six Pack: the semi-automatic preventative, corrective and sanctioning procedures it has prescribed – especially those related to correction and sanctioning – strengthen the role of the Commission, whose recommendations are now less likely to be affected by Council decisions. Whereas in 2003 the Commission could be outflanked by a joint action on the part of Germany and France during infraction procedures, the recent implementation of the reverse majority rule and mandatory time limits have reduced such a possibility.

In the context of the two treaties that round out fiscal governance and address the macroeconomics of the Eurozone, signatory states cannot adopt the entire *acquis communautaire* due to political and juridical objections raised by non-participating states. On the other hand, member states could have opted for an institutional framework that was entirely intergovernmental. The solution is to split the difference and choose a path that lies approximately midway between the two alternatives, although both lean towards the Community method, particularly with regard to the TSCG. The ESM presents an additional challenge in terms of coordination: this fund, which was created as a stability mechanism, depends upon contributions from signatory governments that must be approved by national parliaments; therefore, if the Commission were not only to have the power of initiative, but also legislative decision-making powers, it would raise serious questions regarding its legitimacy (not to mention legality). Therefore, both treaties implicate EU institutions, but are worded so as not to grant them additional powers, but rather invite them and permit them to take certain actions.

The Commission

Contrary to what one might suppose at first glance, the Six Pack and the TSCG have strengthened the role of the Commission. The former has provided semi-automatic monitoring and correction procedures that are directly triggered by reports and recommendations issued by the Commission, thus reducing the power of the Council and consolidating the Commission’s relations with the ECJ in matters related to sanctions. The Commission’s responsibilities regarding the supervision of states’ obligations under the Fiscal Pact are analogous to those set out for it in the Six Pack. The Commission is charged with verifying states’ fulfilment of their obligation to develop national legislation regarding the “golden rule” and the debt brakes required by the TSCG. As part of this verification process, the Commission must present a report on the dispositions adopted (for inclusion in national legislation as per Article 8.1 of the TSCG) to the High Contracting Parties involved. It is true that the Commission’s role is smaller than that outlined in initial drafts of the treaty, which contemplated an infraction procedure initiated by the Commission. However, it is equally true that the application of the reverse majority rule to supervision and correction procedures for both the Six Pack and the TSCG, as well the shorter timeframes allowed to the Council for rejecting the Commission’s proposals, both strengthen the Commission’s position. Furthermore, according to the TSCG, it is the Commission’s mission to propose common principles “concerning the nature, size and timeframe of corrective actions to be undertaken, even in exceptional circumstances, as well as the role and independence of the institutions responsible at the national level for monitoring the observance of these rules”. In other words, the Commission

can propose an increase in states' revenue-raising capacities and/or their spending capacities. It also has an expanded role in the ESM (an international organisation), which relies on the Commission's "technical knowledge" for its operations: any disbursement of financial assistance to a beneficiary member state is contingent upon a related Commission report (Article 17.5).

The promotion of the Commissioner for Economic Affairs to the position of Vice-President for Economic Affairs and Financial Affairs and Commissioner for the Euro highlights the growing importance of this post. In addition, this commissioner (as well as the president of the ECB) participates in the meetings of the ESM's Board of Governors as observers. There are indications that this position will be invested with greater powers in the future, as the German government has already suggested the possibility of granting this commissioner the power to veto national budgets. Furthermore, Angela Merkel has proposed that this position enjoy a status similar to that of the competition commissioner, whose decisions do not require the agreement of the rest of the members of the College of Commissioners. If there are any lingering doubts as to Europe's agenda for the future, the Future of Europe Group has dispelled them by proposing that the Commission be strengthened "so that it can fully and effectively fulfil its indispensable role as the engine of the Community method".

An assessment of the Commission's performance from the perspective of political leadership does not afford such a positive picture; it is clear that it is not adequately equipped for such a role and one might well ask whether, in fact, the Commission has provided leadership for the Union since Jacques Delors held this position. It is notable that the president of the Commission

acts in tandem with the presidents of other institutions more frequently now, especially with the president of the European Council. In fact, the TSGG grants the Commission president a role in Euro Summits, as he or she collaborates with the president of the Euro Summit in the planning of these events (Article 12.4).

In practice, the relations between the presidents of the European Commission and the European Council are simultaneously marked by a spirit of cooperation and a sense of rivalry. If the development of proposals on emergency measures such as the new treaties and the Six Pack provided an opportunity to see these attitudes in play in 2011, they were evident once again in 2012 during the forging of proposals for the future of Europe. Although Barroso participated in the drafting of the Van Rompuy report, he also took pains to express the Commission's own positions on this subject. During his 2012 State of the Union speech to the European Parliament, Barroso proposed a "decisive deal for Europe" that called for the completion of economic and monetary union (moving forward with the single market and banking union), and parallel efforts towards political union. However, his only specific proposal was for European political parties to present their candidates for the post of Commission president in preparation for the upcoming elections in 2014. Barroso also called for a federation of nation states, which would require changes to existing treaties that the Commission plans to propose prior to the 2014 elections. This speech anticipated the publication of the Commission's communication *A Blueprint for a deep and genuine economic and monetary union*, which was presented in November 2012 and outlines three phases of future EU development: the short term (6 to 18 months), during which the focus would be banking union and a new convergence and

competitiveness instrument; the medium term (18 months to 5 years), during which the emphasis would be on economic coordination; and the long term (beyond 5 years), which contemplates the establishment of an autonomous euro area budget that would provide a fiscal capacity for the EMU to help member states to absorb potential economic shocks. The Commission also proposed the joint issuance of public debt (which was subsequently rejected by Germany). The Van Rompuy report incorporated the model of phases proposed in the Commission's Communication.

The European Court of Justice

The role of the European Court of Justice has also been strengthened, not only in the context of the traditional EU framework, but also within the newly created parallel architecture. The Court has become the TSCG's enforcement mechanism regarding the fulfilment of states' obligations, wielding the same power to impose sanctions in the case of non-compliance that it exercises on Six Pack obligations. Any state that is party to the treaty may request the ECJ to issue a judgment as to whether another signatory state has fulfilled its obligation to enact national legislation setting debt ceilings and ensuring the activation of automatic brakes if stipulated deficit levels are exceeded. The states in question must comply with the terms of the ECJ's judgment. The Court's role is not as broad as contemplated in early drafts of the treaty, in which it extended to Title III in its entirety rather than only Article 3.2; it also performs important functions in the more clearly intergovernmental ESM, including the responsibility for settling disputes that may arise between member states and issuing binding judgments (Article 37.3).

The Central European Bank

Along with the Commission and the ECJ, the ECB is another technical organism that has been strengthened during the crisis. The bank has played a crucial role in the management of the crisis vis-à-vis both member states and financial markets. On one hand, the ECB pressured certain states (more or less behind the scenes) to carry out structural reforms that were considered essential to ensure the stability of the euro. On the other hand, Draghi's September 2012 public statement that the ECB was ready to intervene in the sovereign debt market (an action that some Germans considered overstepped the bank's mandate) was clearly directed to the financial markets. Thanks to its technical profile and the actions it has undertaken, the ECB has gained a certain degree of influence over the design of regulations related to macroeconomic and budgetary governance. For example, the ECB has continually pressed for automatic mechanisms to be embedded in monitoring, correction and sanctioning procedures. The ECB has inevitably acquired new responsibilities in relation to the two new international treaties negotiated by euro-states. Those corresponding to the ESM treaty include the provision of expert analyses to detect exceptional circumstances in financial markets (Article 18.2), which are considered essential to the activation of corrective mechanisms contained in the pact. A vote of urgency can be activated on the basis of reports issued by the ECB (and the Commission) and the ECB is also charged with monitoring compliance with the conditions established in Memorandums of Understanding (MoUs) (Article 13.3 and 13.7). Reforms proposed for the future also point to a further expansion of the ECB's role and functions. For example, in a departure from recommendations contained in the 2009 Larosièr

report, in October 2012 the European Council decided that the ECB would serve as the new single supervisory mechanism. The explanation given for this decision was that the ECB had a higher profile than the European Banking Authority (EBA), the interim authority created in 2009. The 5 December Van Rompuy report also called for the creation of a single resolution mechanism to deal with the liquidations of failed banks that would mitigate obstacles to resolution, such as national bias and cross-border cooperation frictions. Although the definition of this mechanism and the ECB's assumption of this role both remain pending, one clearly sees that it is part of a growing trend toward the depoliticisation and parallel "agencification" of European institutions.

The Role of Parliaments

The marginalisation of parliaments compared to the growth of technical organisms can be explained – if not justified – by the fact that they increase the transaction costs of decision-making rather than reducing them. The reality is that the increasing powers bestowed on the European Parliament respond to a different demand and justification: the democratic legitimacy of the European Union. The need to produce swift and decisive responses to crises constitutes a dilemma for national parliaments; the fact that in many cases needed measures run contrary to the desires of electorates has greatly impaired the ability of these institutions to participate in decisions on core policies related to European constitutional reform. Nevertheless, the effective participation of national parliaments is intimately related to the relative weakness or strength of their respective states. A reduction of parliamentary strength would not be credi-

ble, for example, in the case of the German Bundestag.

Insofar as the European Parliament is concerned, the provisions contained in the European Dialogue and the Six Pack – which share the same structure and are worded identically concerning fiscal and macroeconomic preventative and corrective procedures – lay out a passive role for this organism: its relevant commission – economic and monetary affairs – may invite authorities (the presidents of the Commission and Council, and when appropriate the presidents of the European Council and the Eurogroup) to discuss decisions taken in Excessive Deficit Procedures (EDPs) and Excessive Imbalance Procedures (EIPs). The same parliamentary commission can also offer an implicated country to participate in an exchange of perspectives. The role of the EP is broader in the context of the "European Semester", given that the Economic and Financial Committee, the Economic Policy Committee, the Employment Committee and the Social Protection Committee must be consulted whenever appropriate. Nevertheless, even in the most optimistic and positivist light, an interchange of points of view falls short of what could be considered "democratic legitimisation" (or control).

A series of dispositions contained in the Six Pack and the TSCG have eroded the role of national parliaments. To begin with, the creation of a multi-year EU budget framework limits the role of parliaments and the changes they may undergo as a result of democratic elections. New political agendas that may emerge with a change of government are shackled by the obligation to honour prior commitments to multi-year EU budgets. Article 11 of Directive 2001/85 enters into an ironic contradiction, in that it makes no provision whatever for a new (democratically elected) government to update its MTBO forecasts. It is a foregone conclusion that

such updates must be carried out in line with previously agreed frameworks.

The Six Pack does contain a few programmatic references to the participation of national parliaments. The preamble of Regulation 1175/2011 (number 58) states that national parliaments must adequately participate in the European Semester and develop and submit stability and convergence programmes that take national reform programmes into account with an eye to enhancing transparency and building a stronger sense of national ownership of commonly agreed rules and policies. Notwithstanding, on balance, the participation of national parliaments in national stability and convergence programmes, as well as national reform programmes – in other words, at both fiscal and macroeconomic levels – is meagre. According to the record, in September 2012 only 12 parliaments had been *consulted* regarding the elaboration of the national stability and convergence programmes and another six had been *informed* (an indication of their passive role in the process). There was no status reference at all for six cases, leading one to conclude they played no role at all. It must be noted that the parliaments of the three states subject to adjustment programmes have no obligation to submit these reports as they respond to other types of commitments. Concerning national reform programmes, seven governments had consulted their parliaments, four had informed their parliaments and no information was available on this for 13 other states. As far as Spain is concerned, neither programme mentions the Spanish Parliament as having had a role in their development.

The TSCG includes a proposal relative to the promotion of a conference of representatives of relevant committees of the EP and representatives of the relevant committees of national parliaments for the purpose of discussing budget-

ary policies and other issues covered by the treaty (Article 13). The ESM treaty stipulates only that its board of governors make the annual report of the board of auditors accessible to national parliaments (Article 30.5). In contrast, in its decision on the Greek bailout, the German Constitutional Court affirmed that, under the German Constitution, decisions related to revenue and expenditure must remain in the hands of the Bundestag, as this is a fundamental competence of democratic states. As elected representatives of the people, members of parliament must maintain control of fundamental budgetary decisions in a system of intergovernmental governance as well.

Generally speaking, parliaments have not been strengthened by the 2011–2012 reforms. This is because, contrary to the roles of the Commission, the ECJ and the ECB, the role of parliaments in governance is not centred on their utility for improving coordination between states, but rather on the ideational resources they provide and that make them depositories of democratic legitimacy. Following Van Rompuy's February 2012 remark to the effect that national parliaments had become "in a way" European institutions, there has been a growing need to include them in the design of future institutional reforms. It follows that in her address to the European Parliament in November 2012, Angela Merkel defended the theory that as the competences assumed by the EU grow and are strengthened, so too should the powers of the European Parliament. The Van Rompuy report, presented on 5 December, elaborated further on this theme, enumerating a series of proposals, including the creation of future mechanisms to facilitate information, reporting and transparency to national parliaments and national parliaments' participation in integrated financial, budgetary and economic policy frameworks, the

latter related to bilateral agreements worked out between the member states and the EU. The report also alludes to the European Parliament itself, arguing that the creation of a new fiscal capacity for the EMU with the Eurozone should entail agreements that ensure its complete democratic legitimacy and *accountability*. The report of the Future of Europe group was even more ambitious, taking the thesis of democratic responsibility as a given and proposing that the EP be consulted during the European Semester before adopting annual growth forecasts and whenever specific recommendations are approved that affect the EU or the Eurozone. The same report also coincides with Barroso in proposing that the parties present their candidates for president of the Commission in anticipation of the 2014 elections. In summary, the predominant programmatic discourse suggests that steps toward enhanced parliamentary participation will be included in upcoming reforms.

Conclusion

The shift towards intergovernmentalism denounced in some quarters appears to be more

an emergency solution that is, above all, a transient step on the path towards communitisation rather than an authentic rearticulation of a new and definitive model for EU decision-making. Several of the factors identified, such as Franco-German leadership, have been a constant throughout the process of integration, although the emergence of German unilateralism must be considered a somewhat recent phenomenon. From an institutional perspective, those community institutions whose profile is more technical than representative, such as the Commission, the ECB and the European Court of Justice, have been strengthened by the changes introduced, as they reduce the costs of transaction between member states. On the other hand, the provisional losers in these processes have been the more purely representational institutions, both national parliaments and the European Parliament, although upcoming reforms may grant them greater levels of power. This will greatly depend on the ideational resources they provide – the force of ideas – to forge a constructive and lasting bond between democracy and representation and economic and monetary governance.

European Citizenship and Welfare State

The Political Repercussions of the Crisis. Democratic Legitimacy in Europe

Enrique Ayala

Introduction

Four years of the worst economic crisis in Europe since the 1930s have inevitably had a political impact at every level, affecting both the internal politics of Member States and the operation and cohesion of the European Union as a whole. The political consequences of economic crisis will presumably not be as dramatic as they were in the 1930s, however: if the EU has one indisputable achievement to its name, this is its success in making the conflicts that formerly racked the continent a thing of the past. However, many of the effects felt during the inter-war period are once again being felt: political change and social confrontation within states; the resurgence of nationalism; the undermining of belief in politics; an increase in the support for anti-system or far right movements; and growing resentment and even hostility between countries that, while unlikely to lead to war, could significantly harm the process of European integration. It therefore seems likely that, even once the economic crisis has passed,

its political effects will continue to be felt for some years.

The Political Consequences of the Crisis in Member States

The most significant impact of the crisis on the internal politics of European countries has been the fall in support for incumbent parties in almost every state in which elections have been held during the past four years. This decline, in some cases dramatic, has above all affected the social democratic parties, and at the last elections in some countries (the United Kingdom, Germany, Spain) they suffered their worst results in decades, confirming at the same time the rightward shift first observed in the European Parliament elections of June 2009.

Both trends were confirmed in the Greek general elections held in May 2012 and then again in June when the first poll failed to produce a government. The Panhellenic Socialist Movement (PASOK), which had obtained an

absolute majority in 2009 with 160 deputies, collapsed to just 41 deputies in May, and slipped even further to 33 in June, losing ground to radical left coalition Syriza, which went from 13 seats in 2009 to 52 in May 2012 and 71 in June 2012. The centre-right New Democracy party rose from 91 seats in 2009 to 108 in May and 129 in June, since when it has led a coalition with PASOK and Greece's other social democratic party, Dimar, thereby barring the way to those parties opposed to complying with the conditions of the EU rescue deal, namely Syriza and the neo-Nazi Golden Dawn party.

In France, the trend towards change was confirmed, although in this case it was the social democrats who were the beneficiaries. In the presidential elections of April/May, the candidate of the French Socialist Party (PSF), François Hollande, defeated the incumbent, Nicolás Sarkozy, with 51.64 per cent of the vote in the second round, against a score of 48.36 per cent for his opponent. This result was confirmed at the elections to the National Assembly in June, when the PSF performed strongly, winning 280 seats. This helped to give them and their allies, the greens and the left radicals, an absolute majority of 331 seats out of a total of 577. This was a historic victory, as the PSF – which campaigned on a manifesto promising growth, employment and the welfare state – has never held so much power in the history of the Fifth Republic. Furthermore, it was the first significant success for the centre-left in a major EU country since the start of the crisis, a development which, given France's importance, could signal the start of a more general shift.

The Netherlands, by contrast, has bucked the trend of governing parties being voted out of office. In the general elections in September, held early after the far-right Freedom Party withdrew its parliamentary support from the

government, the ruling People's Party for Freedom and Democracy, led by outgoing Prime Minister Mark Rutte, which had governed since 2010 in coalition with the Christian Democrats, confirmed its position as the largest party, obtaining 41 seats out of a total of 150 (10 more than in 2010). Rutte continued as Prime Minister, but this time at the head of a grand coalition with the Labour Party, which performed well in winning 38 seats (8 more than in 2010), in a fragmented parliament in which no fewer than 11 different parties are represented.

Slovakia also saw the centre-left taking power, after Direction–Social Democracy won an absolute majority in the March elections. Similarly, in Lithuania, following elections in October, the Social Democratic Party replaced a centre-right government, heading a three-party coalition. In Romania, the Social Democratic Party obtained an absolute majority in elections in December at the head of a broad coalition that also includes centre-right parties. The left has also had other partial victories, such as the success of the Czech Social Democratic Party in elections for a third of the senate seats, in October, or the election of the Social Democrat, Milan Zver, as President of Slovenia.

Despite this progress for European social democracy in 2012, the centre-right continues to be the ruling party in most European Union countries. There are currently eighteen Member States whose heads of government are from the right or the centre-right, in addition to the technocrat Mario Monti in Italy (who has not been elected but can be included within this group), compared to eight countries where the prime minister is a Social Democrat or a Socialist, including Dimitris Christofias, a Communist, who is President of Cyprus. The majority of these eight governments consist of coalitions including parties of the centre or centre-right, with

social democrats holding an absolute majority in only two, France and Slovakia, both of which held general elections during 2012. However, there are other major countries, such as Germany and Italy, where this trend is also starting to appear.

In Germany, the Social Democratic Party (SPD) continued to recover from its disastrous performance in the 2009 general elections, in which it had received its lowest ever share of the vote (23 per cent). In March, in the Saarland, it entered the regional government as part of a grand coalition led by the Christian Democrats (CDU). In May, it won early elections in Germany's most populous region, North Rhine–Westphalia, with the governing coalition parties (the SPD and the Greens) not only retaining power but winning an absolute majority of the seats. The SPD also took control of the region of Schleswig-Holstein, in May, in coalition with the Greens and the Danish minority. In light of these results, as well as the fact that the CDU lost six of the seven regions in which elections were held during 2011 (five to the SPD and one to the Greens), thus relinquishing its majority in the Upper Chamber of the German Parliament (the Bundesrat), it seems that the German political situation could be very different following the general elections in autumn 2013. Although opinion polls continue to suggest that the CDU/Christian Social Union (CSU) coalition, with 38 per cent of the vote, is on course for victory, its partner in government, the Liberal Party (FPD), might not reach the 5 per cent threshold for election to the Bundestag. The CDU/CSU would then be obliged, except in the unlikely eventuality of receiving the support of the Greens (which might, in any case, be insufficient) to enter a new grand coalition government with the SPD (close to 30 per cent in the polls), and this would produce significant change in Berlin's European policies.

In Italy, partial local elections in May and regional elections in Sicily in October confirmed the rise of the Democratic Party (PD), already observed in the local elections of 2011, together with the decline of the PdL (the People of Liberty) and the Lega Nord, and the spectacular rise of the "anti-political" 5 star movement (M5S) led by comedian Beppe Grillo, which won the mayoral race in Parma and took over 10 per cent of the vote in many towns. The position of PD leader Pier Luigi Bersani was strengthened by the participation of over three million voters in the open primaries, a process put forward by Bersani to choose the party's candidate for general elections in February, following the resignation of Mario Monti as a result of the PdL's decision to withdraw its support from his government. Finally, Silvio Berlusconi has decided to run, but the PdL appears to be deep in crisis, and its revived coalition with the Lega Nord may struggle to achieve 30 per cent of the vote, particularly given the likely rise of a centrist alliance, led by Monti, which could take up to 12 per cent. According to the polls, the PD will win the elections, gaining, together with its coalition partners, 40 per cent of the vote, and Bersani will be able to form a government, although he may require the support of Monti, given the long-standing fragmentation of Italian politics, exacerbated by the rise of the M5S, forecast to poll around 10 to 11 per cent of the vote.

If the predicted rise of the SPD in Germany and of the PD in Italy is confirmed in 2013, and they enter government as a result, this would continue the political trend first observed in France. It could, in turn, be the start of a more general cycle of recovery for the centre-left throughout the EU, with major implications for the policies adopted to deal with the economic crisis and, more generally, the design of the future of European integration.

The Growth of Anti-system and Far-right Movements

The obvious inability of European governments and of the EU to offer solutions to the crisis, or to alleviate its impact, is giving rise to a wave of discontent among citizens, and the rejection both of politicians and of traditional political activity, a development that could endanger the democratic and social health of member states and threaten the cohesion of the Union as a whole.

For example, in Italy, according to a political survey by Demopolis, trust in the political class has fallen to 3 per cent – down from 20 per cent in 2008 – the lowest level of the past 30 years. In Spain, according to the November survey of the Centre for Sociological Research, 67.5 per cent of respondents expressed little or no satisfaction with how democracy works, and in the same poll political parties and politics were rated the third most serious problem in the country, after unemployment and the economic situation.

At the European level, according to the Special Eurobarometer Survey on the Future of Europe, published in April, 89 per cent of Europeans entirely agreed or tended to agree that there was a big gap between public opinion and the decisions taken by leaders. In the Standard Eurobarometer Survey 78, published in December, the level of trust in political parties stood at 15 per cent, compared to a figure of 80 per cent for those expressing mistrust, with only 49 per cent of interviewees saying they were satisfied with how democracy worked in their country, matched by 49 per cent who were dissatisfied; in 14 member states dissatisfaction was the majority opinion. Finally, according to the Special Eurobarometer Survey on Corruption, published in February, the majority of Europeans (74 per

cent) believed that corruption was one of the main problems in their country, although the percentage varied greatly between different countries, with the highest figure in Greece (98 per cent) and the lowest in Denmark (19 per cent). In addition, almost half (47 per cent) believed the level of corruption in their country had risen over the past three years, compared to 7 per cent who believed the level had fallen. Some 57 per cent of Europeans believed their national politicians were involved in bribery or abuse of power.

These alarming figures are finding expression in the appearance or growth of radical parties that do not offer realistic solutions to the situation, such as Syriza in Greece, or directly populist ones, such as Beppe Grillo's M5S in Italy, that provide an outlet for voters' feelings of discontent towards traditional parties, above all in those countries where the crisis has had the greatest impact. Rejection of the political management of the crisis and distrust of politicians are also at the roots of the "occupy" movements that have spread to many European countries. While these spontaneous movements give voice to an understandable and indeed healthy expression of social discontent, there is a danger that they will drift towards anti-democratic populism because they lack both structure and coherence, and do not offer any alternative to the representative democracy on which a state governed by the rule of law must be based.

However, the most worrying development has unquestionably been the rise in many countries of far-right parties and movements, xenophobic and Europhobic formations that owe their birth to fear and selfishness, in response to the arrival of immigrants and progressive union with other European countries, and that are now fed by populist demagoguery which plays

upon the desperation of the working and middle classes, and their very real fear of social exclusion.

The presence of these parties on the European political scene is not new. In 1999, the Freedom Party of Austria (FPÖ) came second in the legislative elections and was a member of the government led by the People's Party until 2005. In Italy, the Lega Nord (LN) was created in 1989, and intermittently participated in three Berlusconi governments between 1995 and 2011. In Belgium, Flemish Interest (VB) was created as the Flemish Bloc in 2004, but subsequently had to change its name after being prosecuted for racism. The French National Front (FN) was founded in 1972, while the Freedom Party (PVV) was founded in the Netherlands in 2006.

However, the current crisis has given these organisations a real boost. In the European Parliament, following the 2009 elections, 13 countries elected at least one far-right MEP and these parties have a total of 35 representatives in the Parliament. Following the elections of the past five years, the far right is also represented in the national parliaments of 13 member states, while even in those countries where they are not represented there are parties that enjoy significant social support, such as the British National Party or the National Democratic Party of Germany, which is again threatened with being banned. Taken together, xenophobic parties obtained over 15 million votes in their respective national elections.

This trend reached its peak during 2012 in the French and Greek elections. In the first round of the French presidential elections, on 5 May, Marine Le Pen, the candidate of the far right and Europhobic National Front (FN), came third with 17.9 per cent of the vote, the best result in the party's history and higher, even,

than the score achieved by her father when he contested the second round against Jacques Chirac in 2002. Although in the first round of the elections to the National Assembly, on 10 June, the party's share of the vote fell to 13.6 per cent, this was still more than three times higher than the number of votes and percentage obtained in the previous elections, in 2007, and in the second round, without any external support, the party won two seats in the Assembly, where it had not been represented since 1988. In Greece, the neo-Nazi Golden Dawn, a marginal force in 2009, entered parliament following elections in May, winning almost 7 per cent of the votes and 21 seats. While it lost three seats in the June elections, it maintained its share of the vote and, according to opinion polls, could increase this significantly at the next elections. In this respect, the Netherlands has been the exception, with Geert Wilders' xenophobic and anti-European Freedom Party suffering a major electoral setback. It lost a third of its vote compared to the previous elections in 2010, and won nine fewer seats, falling to a total of 15 in a parliament of 150, thereby depriving it of the parliamentary influence it had exercised over the previous government.

It seems unlikely that any of these parties could come to power on its own. However, their political influence in some European states is growing, either as a result of entering government in partnership with conservative parties, as happened in Austria and Italy, or because minority governments rely upon them for support, such as in Denmark between 2001 and 2011, or the Netherlands from 2010 until April 2012, with a clear influence on the policies of these governments. Another negative effect is the indirect influence that these formations or their ideology have on conservative governments, radicalising their policies and pulling

them towards the far right, as has been the case of the Hungarian Civic Union which, under pressure from the rise of the far-right Movement for a Better Hungary, has placed itself at the very margins of democracy.

However, the most negative consequence of the rise of the ideology of hatred is the moral damage it causes to European societies, and this is something that could last for a very long time. Demagogic messages, such as a knee-jerk hostility to politics and, above all, xenophobia, easily take root among the most disadvantaged sectors of society, made desperate by the situation and generally lacking in political education, who are the ones who must compete directly with immigrants for scarce jobs and for increasingly restricted social provisions. Once this message, seeking to make scapegoats of outsiders and foreigners, has taken root in the public conscience, it becomes very difficult to reverse and can create social divisions that endanger both peaceful coexistence within countries and cohesion between member states of the EU.

The Trend towards Internal Separatism

The economic and political crisis through which the EU is living has also had a destabilising effect within some member states, exacerbating existing centrifugal trends, and generally motivated – as at the European level – by a refusal of richer regions to share the burden with poorer ones. In other words, by a form of local selfishness disguised to a greater or lesser extent by identity differences that lend a degree of political cover.

The first region to pursue the separatist path was Scotland, whose First Minister, Alex Salmond, leader of the Scottish National Party, was given the go-ahead by London to hold a binding

referendum on independence before the end of 2014, although current opinion polls indicate that the separatist option will be rejected. Scotland could be followed by Catalonia if the region's leader, Artur Mas, re-elected in November, succeeds in implementing the plans of his party, *Convergència i Unió*, and their allies, *Esquerra Republicana de Catalunya*, to hold a referendum in 2014. However, to do this they will have to overcome the barrier of the Spanish Constitution, which does not permit such a move, and the central government in Madrid appears to be prepared to prevent it. In Belgium, the victory of the New Flemish Alliance (NVA), led by Bart De Wever, in the local elections held in October, could give impetus to that party's plan for the negotiated separation of Flanders, in the event of the result being confirmed at the legislative elections in 2014. By contrast, the fall in support for the Lega Nord in Italy, with the party losing two-thirds of its votes in the local elections in May, has undermined the myth of the artificial region of Padania, together with its separatist pretensions.

Each of these developments is very different, not least because the history of each state is unique. However, the differences stem primarily from the countries' different political and constitutional structures: Belgium is a federal state; the United Kingdom and Spain have granted differing levels of autonomy to their regions; while Italy has accepted only administrative decentralisation. In each case, the legal conditions under which it would be possible to become independent, and the likelihood of this coming to pass, differ widely. It is probably the case that some regional leaders are more concerned with obtaining a more advantageous relationship with their respective central states than with achieving a full independence that, in any case, would be a complicated affair within the EU.

Furthermore, it is clear that none of these regions is interested in gaining an independence that would entail leaving the EU. Renouncing the advantages offered by membership of the Union would have a dramatic impact on their economies and would cause voters to think long and hard before supporting a choice that would mean embarking upon a voyage into the unknown. Exclusion from the EU could put an end to each and every one of these secessionist projects. By contrast, the prospect of automatic membership of the EU as new states would give a huge boost to nationalist parties in these regions, and the trend could also extend to other territories of various Member States of the EU, most obviously the Basque Country in Spain, but also to Brittany and Corsica in France or, over the longer term, Bavaria in Germany or the South Tyrol in Italy. However, it seems clear that European treaties do not permit automatic membership of the EU for secessionist regions.

The Treaty on European Union is very clear about this in Article 4.2:

The Union shall respect the equality of Member States before the Treaties as well as their national identities, inherent in their fundamental structures, political and constitutional, inclusive of regional and local self-government. It shall respect their essential State functions, including ensuring the territorial integrity of the State...

This expressly excludes a region that has unilaterally separated from a member state – that is, one that has not respected the constitutional procedures established by that state – from being recognised by the EU. However, even in the event of the separation being achieved in accordance with the constitutional

provisions and acquiescence of the parent state, as could be the case in Scotland, the new state arising from the split would not be an existing member of the Union, because these are explicitly listed in Article 52 of the TEU, and number 27 in total. To include a new member it would clearly, as a minimum, be necessary to modify this article, and this would require the unanimity of the European Council and the corresponding ratification by each of the member states, without which not so much as a comma of the treaties may be amended. This is the procedure that will be used to admit Croatia, due to become the 28th member in July, and which must be followed by any other state – whether new or old – wishing to join the 28, as established in the procedure for applying for entry set out in Article 49. There is no other way for the EU to admit a new member, and any change to this in the future will require the unanimous approval of the Union's existing members. Finally, with respect to maintaining the European citizenship that the inhabitants of these regions would already have acquired, Article 9 states:

Every national of a Member State shall be a citizen of the Union. Citizenship of the Union shall be additional to national citizenship and shall not replace it.

In other words, losing one's status as a citizen of Belgium, the United Kingdom, Spain or any other Member State simultaneously implies the loss of European citizenship.

There is, then, no room for competing interpretations of the provisions of the TEU in this regard. However, just in case there were any doubts, the European Commission, in response to a question from British Labour MEP Eluned Morgan, ruled in March 2004 that

when a part of the territory of a Member State ceases to be a part of that state (e.g. because that territory becomes an independent state), the treaties will no longer apply to that territory, meaning that a newly independent region would, by the fact of its independence, *become a third country with respect to the Union* and the treaties would, from the day of its independence, no longer apply on its territory.

On 17 November 2012, the President of the Commission, José Manuel Durao Barroso, speaking in Cadiz, confirmed that this interpretation continued to be valid, given that there had been no change in the Treaty of Lisbon regarding this issue.

In any case, responsibility for this issue does not lie with the Commission, whose role is limited to interpreting the treaties, but rather with the European Council, which would decide upon whether to accept the hypothetical re-entry of the new State, an issue on which all Member States have a right of veto. Of course, in this respect a unilateral secession, in which the parent state would no doubt wield its veto, would be very different from a secession agreed between the new state and the parent state, with the possibility that the latter could promote the rapid acceptance of the new state as a member of the Union. However, this could be vetoed – or postponed – by any other member state. From the point of view of the EU, the appearance of new states within existing ones offers no advantages, even if these new political entities were in turn to become member states, and many disadvantages, such as the need to increase the number of Commissioners, reorganise the Commission and a whole host of other administrative complications. For affected states, secessionist movements are an example

of how an economic crisis may cause or increase centrifugal and selfish tendencies, and these can become a source of political instability and institutional weakness, at both the domestic and the external level.

The Growing North–South Divide and the Increase in Tensions between Countries

The intensification and prolongation of the economic and sovereign debt crisis (particularly in Greece), despite successive rescue deals, has seriously damaged the internal cohesion of the EU. It has created a gulf between the countries of the north, who are weathering the crisis (although not benefiting from it) but are tired of the need to fund their southern partners, and the countries of the south, seriously affected by the rigidity of the austerity measures demanded of them in exchange for this support, measures which are strangling their economic growth. An example of the growing reluctance of economically strong European states to support weaker countries can be found in the resistance of Germany, Finland and the Netherlands to the rapid and comprehensive implementation of banking union in the Eurozone, as approved at the European Council in June and – more generally – their unwillingness to see the European Central Bank pursuing a more active policy in defence of the single currency. The countries of the north have increasingly come to view the weakened economies of the south as a burden, and these in turn perceive this attitude as one of self-interest.

This increase in mutual animosity has occurred not only at government level but also between European citizens. Asked, in Eurobarometer 78, whether the crisis had made them feel closer to the citizens of other Member

States, 50 per cent of respondents answered in the negative, with only 44 per cent saying it had. In 18 Member States, those saying “no” outnumbered those saying “yes”.

According to a Harris Interactive survey for the Financial Times, published in August, 54 per cent of Germans believed that Greece should leave the Eurozone, exactly twice the number who said they should stay. Asked whether more should be done to help Greece, 47 per cent disagreed, compared to 26 per cent who agreed. The feelings are mutual. According to a poll published in February by Greek social research institute VPRC, the word “Germany” aroused anger and indignation in 41 per cent of respondents, with a total score for all negative opinions (including deception, fear, anxiety and others) of 63.4 per cent. No less than 79 per cent saw the role of Germany in Europe as negative or very negative, and 76 per cent felt that Germany policy towards Greece was hostile.

The increase in self-interested and nationalist sentiment in a situation of major economic crisis such as that being experienced in Europe is to some degree spontaneous. However, the political class and the media are not innocent in this process of destroying mutual trust and internal European cohesion, which has reached disturbing levels.

Many European politicians have regularly exploited the EU for electoral ends within their own countries, blaming EU institutions or other member states for the overall situation or for specific problems, and have, for years, presented their involvement with EU institutions as a struggle against other members, from which the aim was to emerge with advantages for one’s own country rather than to achieve benefits for the Union as a whole. Nobody has dared to argue openly in favour of solidarity or making sacrifices to support other Member

States on the basis that this would benefit the common project and, therefore, all members of the Union. This has led to the creation of an atmosphere of competition and national self-interest, something which the crisis has only heightened.

At the same time, media campaigns in the richest countries, and in particular in Germany, and the response in the south are causing great damage to cohesion within the EU. So, for example, the German press propagate an image of the Greeks and of the inhabitants of southern Europe in general as lazy and inefficient, and bent on living off the efforts of their northern neighbours, while the Greece media make repeated reference to the memory of Nazi brutality. Aggressive headlines in *Bild*, or the cover of *Focus*, showing Venus making an obscene hand gesture, under the title, “Liars in Euroland. Greece is taking our money. And what about Spain, Portugal and Italy?” or the response of Greek daily *Eleftheros Typos*, showing the Statue of Victory in Berlin with a swastika in her hand instead of the laurel wreath she holds in reality, under the title, “The economic power of the 4th Reich expands”, do not exactly foster mutual understanding between peoples who, it is supposed, share a common political destiny.

There can be no surprise, in this context, at violent events such as the attack on the German Consul in Thessaloniki on 15 November by council employees opposed to a German–Greek meeting, or the violent protests that greeted the visit of the German Chancellor to Athens in October and to Lisbon in November. This is not good news for the Union.

The growth in mistrust and even hostility between European nations, and the resurgence of self-interest and nationalism are probably the worst of the political effects of the economic crisis in Europe, because they are likely to far

outlive the crisis itself. Creating trust and friendship between the peoples of Europe after the Second World War took decades; destroying this could, in some cases, take no more than a couple of years. And this, in turn, will damage the integration process, because without a minimum of empathy between nations there seems little prospect of successfully building a shared political future. Without an effort on the part of the media and politicians, it will be difficult to heal these wounds.

The Democratic Legitimacy Deficit of European Institutions

Europe cannot be built without the express support and commitment of European citizens and this support is declining rapidly due to the inability of the EU to provide satisfactory responses to citizens' problems and to promote a reasonable solution to a situation which, in some countries, is becoming dramatic.

In principle, the majority of Europeans continue to favour Europe; what is being undermined is trust in its institutions. According to Eurobarometer 77, published in June, there is a high level of support for increased decision-making powers at the EU level in all issues about which respondents were asked: the fight against terrorism (85 per cent), promoting peace and democracy in the world (84 per cent), protecting the environment (82 per cent), cooperation in research and innovation (82 per cent), the fight against organised crime (81 per cent), promoting economic growth (73 per cent) and fighting unemployment (64 per cent). In the same survey, Europeans said that they identified with Europe. When asked whether they felt themselves to be citizens of the EU, 61 per cent answered "yes", against 38 per cent who said

"no". There were only two Member States where more people responded "no" than "yes": the United Kingdom, and – surprisingly – Italy, where 16 per cent of interviewees have changed their response during the past year.

In Eurobarometer 78, published in December, 85 per cent of interviewees believe that, as a consequence of the crisis, the countries of the EU need to work together more closely, and when asked which institution is best placed to tackle the effects of the crisis, 23 per cent said the European Union, while only 20 per cent said national governments.

However, European institutions are threatened by the loss of legitimacy in the eyes of their citizens. Legitimacy of origin, because only the European Parliament is directly elected; and legitimacy of practice, because of the general feeling that EU institutions do not represent the interests of citizens, and that they are not taking the right actions to address the difficult times Europe is currently facing. When asked whether the interests of their country are adequately taken into account within the EU, across all 27 member states, 52 per cent said "no" against 41 per cent who said "yes", with this negative perception being the majority opinion in 19 countries. More important still is the answer to the question of whether the voice of individual citizens counts in the Union, because this question directly touches upon the democratic legitimacy of EU institutions. Taken across all 27 member states, 64 per cent of respondents answered "no", against 31 per cent who said "yes", with the "no" camp constituting the majority in no fewer than 25 of the member states. It is worth remarking that even in Germany, a country playing a decisive role in decisions with regard to the crisis, 54 per cent of interviewees believe that their voice is not taken into account, against 42 per cent who believe that it is.

According to the same Eurobarometer survey, the proportion of Europeans who have a positive image of the Union is 30 per cent, compared to 52 per cent in September 2007, while that of those with a negative image has risen from 15 per cent to 29 per cent over the same period; in other words, opinion has shifted by 36 points since the start of the crisis. Asked whether, in general, things are going in the right direction in the EU, only 22 per cent said that they were, against 52 per cent who said that things were going badly.

European citizens even question the transparency and operation of democracy in EU institutions. In the Eurobarometer special on corruption, referred to in Section 2, a large majority (73 per cent) believe there is corruption within EU institutions. This is a majority perception in all Member States, although it varies widely between Austria (where it is the view of 87 per cent of respondents) and Poland (52 per cent). According to Eurobarometer 78, 45 per cent are not satisfied with how democracy functions in the EU, against 44 per cent who are satisfied. Trust in the EU has fallen to 33 per cent, although it is up by two points since June, when it reached its lowest level since the survey was first held in 1973, falling by 26 points from the level of 57 per cent recorded in September 2007. The proportion of interviewees expressing mistrust was 57 per cent (60 per cent in June).

With respect to European institutions, the only one to inspire more trust than distrust among citizens is the European Court of Justice, and this is the second least known institution after the European Council (**Table 1**). The most highly regarded institution of the others, and the best known, is the only one elected by direct suffrage, the Parliament, which receives a trust rating of 44 per cent compared to 45 per cent who said they distrusted it. The rest decline both in terms of the level of awareness and/or of trust, with the European Council being the least well known (71 per cent) and the one to inspire least trust (36 per cent)

Despite this perception on the part of citizens, the reality is that the European Council is the institution responsible for taking the most important decisions, in particular those concerning the economic crisis, making it the central body of the EU, to the detriment of the Commission and the Parliament, which have gradually taken on a subordinate role in the case of the former, and a secondary one in the case of the latter.

This is one of the prime reasons for the democratic deficit and the growing disaffection of citizens towards the EU. The decisions taken by the European Council affect all the citizens of the Union (or of the Eurozone, in some instances) but those who decide are not democratically – or electorally – answerable to

Table 1. Knowledge and level of trust in European institutions

Institutions	Known		Trusted	
	Yes	No	Yes	No
Parliament	91	8	44	45
European Central Bank	85	14	37	49
Commission	85	14	40	44
Court of Justice	76	22	49	34
European Council	71	27	36	43

Source: Eurobarometer 78.

these citizens, but only to voters in their own countries. It is not surprising, then, that rather than defending the collective interests of Europeans, they defend those of their electorates, who are the ones who have granted them the power they wield (and the ones who can take it away).

With respect to the Commission, the decisions it takes, although almost always deriving from decisions of the European Council, also affect the life and prosperity of Europe's citizens, but the Commission is, likewise, not democratically answerable to them. It lacks legitimacy of origin, having been chosen by the European Council, and lacks legitimacy of practice because its decisions often reflect the influence of those member states that carry most weight in the European Council, rather than any more objective or technical criteria.

The Parliament, for its part, has only limited competencies. It does not have full legislative initiative; it shares its legislative function with the Council (consisting of the heads of government of Member States); it can only approve or reject the President and Membership of the Commission, as chosen by the European Council; and it cannot pass a constructive vote of no confidence. In matters relating to the Eurozone or the single currency, it is similarly impotent,

because these are issues that do not affect all of the countries in the Union.

So long as things were going reasonably smoothly in the EU, these problems remained latent. However, the crisis has obliged European institutions – primarily the Council and the Commission – to impose very difficult measures on some countries without the citizens of those countries feeling that these institutions possess the democratic legitimacy to act in this way. This lack of legitimacy becomes unbearable when the transfer of sovereignty is at issue, as is the case of the Treaty on Stability, Cooperation and Governance or the fiscal pact.

The democratic deficit, that leads – as we have seen above – to European citizens rejecting EU institutions and denigrating the EU itself, can be addressed only if decision-making capacities are transferred to EU bodies enjoying a legitimacy granted to them by citizens as a whole (as is the case of the European Parliament, and as would be the case if the Commission were chosen by the Parliament and answerable to it, in the same way that national governments are answerable to their parliaments), and if, at the same time, the competencies of the European Council are restricted to those issues affecting the sovereignty of Member States, EU treaties, and membership of the EU.

Under Pressure: The European Social Model in Times of Austerity

Klaus Busch

The European social model has never been unambiguously defined. The term is sometimes used to describe the reality of the European Union (EU), allegedly different in social aspects from other parts of the world, particularly the USA; on other occasions it is presented as a normative model to which the EU should commit itself.

In this chapter we understand the European social model to encompass six policy goals:

1. a macroeconomic policy aimed at full employment;
2. a wage policy that ensures real productivity-based wage growth and that includes a minimum wage;
3. a social security system that ensures a high level of health, family, unemployment and retirement protection;
4. a strong public sector that provides services of general interest and contributes to employment stabilisation;
5. a high degree of participation and codetermination rights for employees and social dialogue at the European, national and sectoral levels;

6. the inclusion of a social progress clause in the EU Treaty that, at the European level, would prioritise basic social rights over market freedoms.

I shall examine the impact of austerity policies on the European social model, beginning with a brief review of the recession as the outcome of the harsh austerity policies applied in the Eurozone and in the EU during 2012. I shall then examine EU wage policy and pensions policy developments, particularly during 2012, and show how austerity policies have had a clear impact on both, thereby weakening the European social dimension.¹ Finally, I shall

¹ This chapter discusses only wage and pension policies, as areas in which the most significant changes of 2012 occurred. Note that no important decisions were adopted in 2012 with regard to participation rights and the social progress clause. For reasons of space, important public sector changes in southern Europe are excluded. Interested readers are referred to the recent article written by Klaus Busch et al., »Euro Crisis, Austerity Policy and the European Social Model: How Crisis Policies in Southern Europe Threaten the EU's Social Dimension«, February 2013, Berlin, <http://library.fes.de/pdf-files/id/ipa/09656.pdf>

consider the economic and institutional framework for future development of the European social model.

The Euro Crisis and Austerity: an Initial Retrospective

After a brief phase of expansionary economic policy designed to deal with the crisis of 2008–2009, policy quickly switched to austerity, leading to a new economic crisis in 2012. Data on growth rates, fiscal deficits and public debt from 2009 to 2012 bear this out. In the countries in which the severest cuts were applied – namely, Greece, Italy, Portugal and Spain – the economic downturn of 2012 was more severe than in the Eurozone on average; this downturn further contributed to their growing public debt ratios (European Commission, 2012: European Economic Forecast, Autumn 2012, Brussels, *passim*).

Before 2007, average public debt in the EU countries had been falling, thanks to favourable growth indicators. After 2007, the increase in public debt was clearly attributable to expansionary economic policies and bank bailouts. However, since 2010, neoliberal economists have increasingly been able to embed in the popular consciousness the notion that it was not the crisis that caused the rise in debt but vice versa. The Stability and Growth Pact of October 2011, reinforced with a new set of economic and fiscal surveillance rules called the “Six Pack”, and the December 2011 Fiscal Compact, setting a debt limit of 0.5 per cent of GDP, are both underpinned by the argument that the fundamental cause of the crisis is debt and therefore debt must be eliminated.

This misguided economic policy has not only worsened the crisis, it has triggered a profound

social crisis in the Eurozone countries and is jeopardising their welfare systems. Austerity policies have pushed the unemployment rate in the Eurozone up to 11 per cent, the highest since 1995; rates are now above 25 per cent in Greece and Spain and half of the young people in both countries are unemployed. Austerity policies are eroding the European social model.

Austerity and Wage Policy

The crisis and the austerity drive have both had a very negative impact on the social dimension of European integration, especially with respect to wage policy.

In 2012, as in 2011, average real wages fell in the Eurozone and in the EU27 (**Table 1**). Due to their particularly harsh austerity programmes, the most affected countries were Greece, Portugal and Cyprus. However, large falls in real wages were observed not only in these countries, but also in many countries of central and eastern Europe, particularly Slovenia and Slovakia; even the Scandinavian countries were affected. The few exceptions were France, Bulgaria and Latvia, and most especially Germany, which – the only EU country that recorded falls between 2003 and 2007 – had real wage growth rates of 0.9 per cent and 1.0 per cent in 2011 and 2012, respectively.

A similar falling trend was evident in real unit labour costs, which link real wages to labour productivity (**Table 2**). In many countries, trade unions had failed to take advantage of rising labour productivity to obtain a corresponding increase in real wages. This was yet another effect that was more pronounced in Cyprus, Greece, Portugal and Spain, where real unit labour costs fell more than the Eurozone average; nonetheless, some central and eastern European

Table 1. Real compensation of employees per head (percentage change on preceding year)

	5-year averages								Autumn 2012 forecast	
	1993-97	1998-02	2003-07	2008	2009	2010	2011	2012	2013	
Belgium	1.2	1.3	0.0	0.3	1.9	-0.7	0.0	0.5	0.7	
Germany	0.4	0.4	-0.7	0.5	0.2	0.3	0.9	1.0	1.1	
Estonia	:	5.9	9.8	1.7	-1.9	-0.8	-5.0	0.9	1.4	
Ireland	1.5	1.5	3.0	3.7	6.3	-1.0	-1.3	-1.2	-1.3	
Greece	1.6	2.6	0.8	-0.6	2.8	-6.3	-6.5	-7.8	-6.0	
Spain	0.0	-0.1	0.3	3.2	5.6	-1.9	-2.2	-1.8	-0.6	
France	0.8	1.3	0.9	-0.1	2.7	1.5	0.8	0.2	0.2	
Italy	0.0	-0.7	0.5	0.7	1.8	0.7	-1.5	-1.4	-0.7	
Cyprus	:	1.8	0.6	-1.2	1.8	0.6	0.0	-3.7	-2.3	
Luxembourg	0.8	1.2	0.6	0.0	1.0	1.0	-0.6	-0.4	0.6	
Malta	:	3.3	1.5	1.7	1.0	-3.3	-0.1	-1.3	0.0	
Netherlands	0.3	1.6	1.2	2.1	3.0	0.2	-0.5	-0.3	-0.5	
Austria	0.7	1.3	0.2	0.9	2.1	-0.6	-1.3	0.5	0.3	
Portugal	2.2	2.0	0.4	0.5	5.2	-0.2	-4.1	-5.1	0.6	
Slovenia	:	2.2	3.1	1.7	0.8	2.4	-0.1	-2.2	-1.8	
Slovakia	:	2.6	3.4	2.4	2.4	4.0	-2.7	-2.1	0.2	
Finland	0.9	0.8	2.4	0.9	0.9	-0.3	-0.1	0.2	1.3	
Euro area	0.4	0.5	0.2	0.8	2.3	0.2	-0.3	-0.1	0.3	
Bulgaria	:	10.4	3.2	8.6	7.8	8.5	3.4	2.1	2.1	
Czech Republic	:	3.9	4.6	-0.6	-1.4	3.3	2.2	-0.5	0.9	
Denmark	1.1	1.8	2.1	0.8	0.5	0.2	-0.8	-0.5	-0.2	
Latvia	:	2.9	13.2	-0.4	-15.5	-5.1	12.9	0.5	0.4	
Lithuania	:	4.8	9.9	3.1	-13.8	-1.7	-0.6	0.1	-0.5	
Hungary	:	2.8	2.8	1.9	-5.4	-4.0	-1.5	-1.2	-4.1	
Poland	4.0	3.2	0.6	4.4	0.9	2.2	-0.8	-0.3	0.8	
Romania	-1.0	11.7	10.9	19.9	-5.4	-0.2	-1.9	0.9	0.1	
Sweden	2.0	2.3	2.3	-1.5	-0.5	1.3	-0.4	1.9	1.7	
United Kingdom	0.3	3.9	2.1	-1.9	1.3	-0.9	-2.6	0.2	0.5	
EU	:	1.7	0.6	0.2	1.7	0.2	-0.6	-0.1	0.2	

Source: European Commission (2012): European Economic Forecast – Autumn 2012, Table 26, Page 160.
http://ec.europa.eu/economy_finance/publications/european_economy/2012/pdf/ee-2012-7_en.pdf

countries (mainly the Baltic countries) and Denmark, Finland and Sweden also experienced a decline in real unit labour costs. The exception was again Germany: it recorded important increases in real unit labour costs in 2011 and 2012, after having experienced the largest decline of all Eurozone countries (with the exception of Luxembourg) between 2003 and 2007.

The drop in real wages and real unit labour costs in the Eurozone and the EU responds to a number of economic, social and political factors. In the countries most affected by the crisis it was due to the harsh austerity policies imposed by the EU and the financial markets in the context of the fight against the debt crisis. In these countries, economic growth fell at an

Table 2. Real unit labour costs (percentage change on preceding year)

	5-year averages							Autumn 2012 forecast	
	1993-97	1998-02	2003-07	2008	2009	2010	2011	2012	2013
Belgium	-0.4	0.2	-1.0	2.2	2.6	-2.3	0.6	1.2	0.0
Germany	-0.8	-0.1	-1.6	1.5	4.4	-2.0	0.6	1.6	0.8
Estonia	:	-1.7	1.0	8.7	2.8	-6.8	-4.2	1.1	0.0
Ireland	-2.7	-2.6	1.7	9.9	1.0	-4.3	-3.4	-2.5	-2.3
Greece	0.1	0.3	-1.4	0.3	3.8	-1.3	-2.9	-8.2	-3.6
Spain	-1.0	-0.8	-0.7	3.2	1.4	-2.4	-2.4	-2.9	-1.7
France	-0.6	0.1	-0.4	0.7	3.0	-0.4	0.3	0.0	-0.1
Italy	-1.6	-1.2	0.2	2.1	2.4	-0.8	-0.4	0.7	-0.8
Cyprus	:	-0.7	-0.7	-2.7	3.8	-0.5	0.5	-4.2	-0.7
Luxembourg	-0.3	0.4	-2.9	8.9	6.8	-5.6	-1.7	1.9	-0.5
Malta	0.8	-0.2	-0.2	0.5	3.4	-4.1	-0.9	-1.8	-0.7
Netherlands	-1.0	0.1	-0.8	0.8	5.2	-1.8	0.0	1.0	-0.2
Austria	-0.6	-0.7	-1.1	1.8	3.4	-1.8	-1.2	1.1	0.3
Portugal	-0.1	-0.1	-0.6	1.9	2.2	-2.6	-1.3	-4.3	-0.6
Slovenia	:	-0.6	-0.7	2.1	4.7	1.5	-1.6	0.1	-0.8
Slovakia	:	-0.7	-0.9	1.5	7.0	-1.4	-2.0	-3.7	-1.5
Finland	-2.9	-0.8	-0.1	3.7	7.4	-2.0	-1.3	0.8	0.3
Euro area	-1.0	-0.4	-0.8	1.8	3.3	-1.5	-0.3	0.2	-0.1
Bulgaria	:	0.9	-1.6	3.7	8.1	2.7	-3.7	1.3	0.8
Czech Republic	:	0.4	0.0	1.5	-0.1	1.4	1.9	2.6	-0.3
Denmark	-0.8	0.6	0.1	1.8	4.5	-4.6	-0.4	-0.4	-1.4
Latvia	7.8	-3.6	3.2	6.9	-6.7	-9.2	-2.8	-1.8	-1.7
Lithuania	:	-1.0	0.7	0.7	2.0	-8.8	-5.3	-0.1	-2.2
Hungary	:	-0.4	-0.2	-0.9	-0.7	-3.3	-1.3	2.2	-3.2
Poland	-1.4	-1.3	-3.2	4.3	-1.4	-0.1	-2.3	-0.8	-0.5
Romania	-5.0	2.5	-1.7	6.6	-1.2	1.8	-5.9	-0.2	-0.8
Sweden	-0.7	0.5	-0.9	-0.1	2.3	-3.2	-1.8	1.2	0.1
United Kingdom	-1.7	1.0	-0.3	0.2	3.9	-1.6	-1.1	1.1	-0.2
EU	:	-0.3	-0.9	1.4	3.2	-1.5	-0.6	0.3	-0.2

Source: European Commission (2012): European Economic Forecast – Autumn 2012, Table 29, Page 162.

http://ec.europa.eu/economy_finance/publications/european_economy/2012/pdf/ee-2012-7_en.pdf

above average rate and unemployment rates soared, leading to a very difficult context for unions to negotiate wage demands.

Weak wage performance was also due to political interventions. Throughout the euro crisis the EU developed a new wage policy mechanism (the Euro Plus Pact and the Six Pack), involving major interventions in the collective

bargaining systems of the countries in crisis. The binding nature of collective agreements was undermined in favour of the decentralisation of collective bargaining. Furthermore, as part of the austerity drive, public sector wages were frozen or reduced.

Two factors explain the decline in real wages and real unit labour costs in many countries of

central and eastern Europe. First, the economic crisis of 2008–2009 hit many countries of this region particularly hard, resulting in soaring unemployment. Furthermore, the unions in these countries are particularly weak, with a degree of organisation and levels of implementation of collective agreements well below the average for the rest of the EU.

Economic conditions in the countries of northern Europe (especially Denmark and Finland) also deteriorated and the organisational power of unions likewise declined. In Sweden, in particular, unemployment insurance system reforms debilitated trade union organisation, although in the European context, this remains well above average.

The situation in Germany has two explanations. First, Germany has a strong position in emerging markets and so has recovered well from the crisis of 2008–2009, achieving very high growth rates of 3.0 per cent and 3.5 per cent in 2010 and 2011, respectively, and experiencing a sharp fall in unemployment. Second, in the decade before the crisis, the above average decline in unit labour costs in Germany led to a very high surplus in the current account balance. This situation was criticised by its European partners and, consequently, many member states, but also the European Commission, the IMF, the World Bank and the OECD recommended that Germany adopt more expansionary policies to stimulate domestic consumption and, through increased imports, to bring down its balance of payments with other member countries. This political pressure on Germany by other EU member countries underpinned the bargaining position of German unions and curbed the fall in real wages in recent years.

EU Pensions Policy: From the Lisbon Strategy to the White Paper

EU involvement in pension policies commenced early this century with the Lisbon Strategy, launched by the EU in 2000. In the previous decade, however, many European countries had already implemented key reforms. Sweden, Poland, Latvia and Hungary initiated the most radical reforms. The most important features of these reforms were as follows: the combination of various types of pension funding (social security contributions, private pension funds, tax-based systems); enhanced proportionality between benefits and contributions; higher retirement ages, usually at least 65 years for men and women alike; reductions in the amount of future pensions; greater restrictions on early retirement; and measures to increase employment, particularly in the 55–64 age group.

These reforms of the 1990s constituted the starting point for the Lisbon Strategy. Because it has no competences in key social policy areas such as health, pensions and poverty, the EU introduced a new governance tool, the open method of coordination (OMC), by means of which the EU seeks to indirectly influence member state policies. This was clear evidence that, within the framework of the Lisbon Strategy, the EU was pursuing not only economic but also social goals.

With regard to pension schemes, the objectives agreed in three rounds of OMC negotiations between 2001 and 2007 were shaped by two overarching goals: ensuring the financial sustainability of pension systems in the face of demographic challenges, while simultaneously ensuring satisfactory pension levels that prevent old-age-poverty. There clearly has to be a trade-off between these two main goals: the more

success is achieved with one goal, the more success with the other goal is jeopardised.

This is evident from European Commission forecasts regarding EU27 pension systems up to 2060. Reforms (especially those that reduce pensions and increase the employment rate) will contribute to economic sustainability in the EU27. Without reforms, public expenditure on pensions as a share of GDP will increase by 9 percentage points by 2060, whereas with reforms, this increase in GDP share will be held to just over 2 percentage points. In many countries, the goal of social adequacy for pensions will be threatened. **Table 3** shows that reforms will cause the gross replacement rate to fall dramatically from 2007 to 2060 in most member states, affecting particularly public pensions. This reduction – to below 50 per cent in most countries by 2060 – points to a dramatic increase in the risk of poverty in retirement. (European Commission, 2012: The 2012 Ageing Report: Economic and Budgetary Projections for the EU27 Member States (2010–2060), European Economy 2/2012. Brussels.)

The White Paper on Pensions Policy

In its 2010 Green Paper and 2012 White Paper on adequate, sustainable and safe pensions, the European Commission responds to the discrepancy between financial sustainability and the social objective of pension adequacy. While the Green Paper primarily reflects the positions of member countries and their respective pension policies, the White Paper contains European Commission recommendations on pension policy, focusing on higher retirement ages.

The White Paper makes the following key recommendations (European Commission, 2012: White Paper – An Agenda for Adequate,

Safe and Sustainable Pensions, Brussels, 16.2.2012 COM(2012) 55 final, p.9):

- *link the retirement age with increases in life expectancy;*
- *restrict access to early retirement schemes and other early exit pathways;*
- *support longer working lives by providing better access to lifelong learning, adapting workplaces to a more diverse workforce, developing employment opportunities for older workers and supporting active and healthy ageing;*
- *equalise the pensionable age of men and women; and*
- *support the development of complementary retirement savings to enhance retirement incomes.*

These recommendations emphasise, above all, retirement age increases, both legal and real. With this policy of increasing both the statutory and effective retirement age, the European Commission hopes to satisfy the two main objectives of pension reforms: securing the financial sustainability of pension schemes, while maintaining the adequacy of pension benefits (through a higher replacement rate).

However, there are many doubts about the possibilities of increasing the replacement rate. **Table 4** shows how many EU countries managed to increase the retirement age (by one or two years) between 2001 and 2008; however, a gap of four to five years between the effective and the legal retirement age is typical. Note also that the positive social effects of the increased retirement age are cancelled out, as can be observed for countries that have already agreed to raise the legal retirement age from 2020 (the Czech Republic, Denmark, Germany, Ireland, Greece, Lithuania, Malta, Austria, Romania and the United Kingdom): the effective retirement age is higher after 2020, but replacement rates do not increase. This means

Table 3. Benefit ratios in EU member states in 2007 and 2060

	Benefit Ratio (%)					
	Public pensions			Public and private pensions		
	2007	2060	% change	2007	2060	% change
BE	45	43	-4			
BG	44	36	-20	44	41	-8
CZ	45	38	-17			
DK	39	38	-4	64	75	17
DE	51	42	-17			
EE	26	16	-40	26	22	-18
IE	27	32	16			
EL	73	80	10			
ES	58	52	-10	62	57	-8
FR	63	48	-25			
IT	68	47	-31			
CY	54	57	5			
LV	24	13	-47	24	25	4
LT	33	28	-16	33	32	-2
LU	46	44	-4	46	44	-4
HU	39	36	-8	39	38	-3
MT	42	40	-6			
NL	44	41	-7	74	81	10
AT	55	39	-30			
PL	56	26	-54	56	31	-44
PT	46	33	-29	47	33	-31
RO	29	37	26	29	41	41
SI	41	39	-6	41	40	-2
SK	45	33	-27	45	40	-11
FI	49	47	-5			
SE	49	30	-39	64	46	-27
UK	35	37	7			
NO	51	47	-8			

Source: European Commission, Brussels, 7.7.2010, COM(2010)365 final, Green Paper towards adequate, sustainable and safe European pension systems, SEC(2010)830, p. 27.

Note: The 'Benefit ratio' is the average benefit of public pension and public and private pensions, respectively, as a share of the economy-wide average wage (gross wages and salaries in relation to employees), as calculated by the Commission. Public pensions used to calculate the Benefit Ratio includes old-age and early pensions and other pensions. Private pensions are not included for all Member States. Hence, the comparability of the figures is limited. The value of indicators might change as some Member States consider reforms of their pension systems (e.g. Ireland).

that people work for longer but do not receive a correspondingly higher pension.

Achieving the two objectives of restoring financial health and ensuring social adequacy will ultimately depend on how employment rates unfold in the EU countries. **Table 5** shows that employment rates in the EU were higher in 2011 than in 2001 – a positive development as

far as economic sustainability and the social adequacy of pensions are concerned. However, employment rates fell again from the crisis of 2008–2009, mainly affecting the countries most hit by the euro crisis, namely, Greece, Ireland, Latvia and Portugal.

Table 6 depicts a similar scenario for one particular age group. Since 2001, EU employment

rates for the 55–64 age group have increased, even if the level remains well below the average for the other age groups. This trend, although less pronounced from 2006, was maintained in most countries. However, in countries where the austerity drive was especially harsh – Greece, Ireland, Latvia, Portugal and Romania – the employment rates for the 55–64 age group declined from the second half of the decade.

The Impact of Austerity on Pension Schemes

As for pension schemes and how austerity has affected them, a distinction has to be drawn between systemic reforms, on one hand, and the effects of the crisis on the economic sustainability and social adequacy of pensions, on the other.

During the years of the euro crisis, major systemic reforms were implemented in Greece, Italy

Table 4. Standard pension eligibility age and average labour market exit age

Member State	Average exit age from the labour force in 2001	Average exit age from the labour force in 2008	Statutory retirement age for M/W in 2009	Statutory retirement age for M/W in 2020	Further increases in the statutory retirement age for M/W after 2020
Belgium	56.8	61.6*	65/65	65/65	
Bulgaria	58.4	61.5	63/60	63/60	
Czech Republic	58.9	60.6	62/60y8m	63y8m/63y4m	65/65
Denmark	61.6	61.3	65/65	65/65	67+/67+***
Germany	60.6	61.7	65/65	65y9m/65y9m	67/67
Estonia	61.1	62.1	63/61	63/63	
Ireland	63.2	64.1**	65/65	65/65 (66/66)	(68/68)
Greece	61.3°	61.4	65/60	65/60	65/65
Spain	60.3	62.6	65/65	65/65	
France	58.1	59.3	60-65	60/60	
Italy	59.8	60.8	65/60	65/60****	***
Cyprus	62.3	63.5*	65/65	65/65	
Latvia	62.4	62.7	62/62	62/62	
Lithuania	58.9	59.9**	62y6m/60	64/63	65/65
Luxembourg	56.8	:	65/65	65/65	
Hungary	57.6	:	62/62	64/64	65/65
Malta	57.6	59.8	61/60	63/63	65/65
Netherlands	60.9	63.2	65/65	65/65 (66/66)	(67/67)
Austria	59.2	60.9*	65/60	65/60	65/65
Poland	56.6	59.3*	65/60	65/60	
Portugal	61.9	62.6*	65/65	65/65	
Romania	59.8	55.5	63y8m/58y8m	65/60 (65/61y11m)	(65/65)
Slovenia	56.6°	59.8**	63/61	63/61 (65/65)	
Slovakia	57.5	58.7*	62/59	62/62	
Finland	61.4	61.6*	65/65, 63-68	65/65, 63-68	
Sweden	62.1	63.8	61-67	61-67	
United Kingdom	62.0	63.1	65/60	65/65	68/68
EU 27 average	59.9	61.4			

Source: European Commission, Brussels, 7.7.2010, COM(2010)365 final, Green Paper towards adequate, sustainable and safe European pension systems, SEC(2010)830, p. 30.

and Spain, while Portugal had already implemented comprehensive reforms between 2002 and 2007. The most important elements of the reforms undertaken were as follows:

- the retirement age was gradually and markedly increased to take into account increases in life expectancy;
- pensions were drastically reduced by changing the calculation formula (for example, greater proportionality between contributions and pension);
- specific regulations governing certain professions were abolished;
- more restrictions were imposed on early retirement and incentives were introduced to postpone retirement.

For the standard pensioner (average income; 40–42 years of contributions; compliance with statutory retirement age), these reforms will have a significant impact on the gross replacement rate. Between 2011 and 2040, its rate will fall as follows: from 59.3 per cent to 46.2 per cent in Greece; from 79.5 per cent to 69.5 per cent in Italy; from 72.4 per cent to 57.6 per cent in Spain; and from 56.9 per cent to 51.2 per cent in Portugal (European Commission (2012): *The 2012 Ageing Report: Economic and Budgetary Projections for the EU27 Member States (2010–2060)*, European Economy 2/2012. Brussels).

The above forecasts will be met only if there are no breaks in the working lives of the active population; however, this will be very difficult to achieve on the basis of current trends, especially in southern Europe: the dramatic rise in unemployment in 2011 and 2012 – a direct result of the crisis and of severe austerity policies – will lead to many interruptions in working lives. In this region, as can be observed in **Table 6**, the already low employment rates of people close to retirement age will be further intensified.

Moreover, the ongoing economic crisis will add to the proportion of workers experiencing precarious working conditions (part-time work, temporary work and mini-jobs). As a consequence, fewer people will be able to aspire to a standard pension in the future and the percentage of the workforce at risk of poverty in old age will be higher.

Beyond 2012: The Economic and Institutional Framework for a European Social Model

Analyses of wage and pension policies make it clear that the bargaining position of trade unions in the EU has weakened sharply due to unemployment, but also due to political interventions in collective bargaining systems. The data on real wages and real unit labour costs speak for themselves. Neoliberal reforms continue to be applied to pensions: restructuring based on greater proportionality between contributions and pensions, higher retirement ages and reduced replacement rates. These tendencies are being reinforced by austerity drives. The European social model is in serious jeopardy.

Given these depressing trends, what can we expect from 2013 and beyond? A policy change that improves the situation? Or a continuing downward trend?

Economic Conditions: Muddling Through

It is difficult to predict what changes could occur in the economic environment from 2013 and beyond. Three scenarios are possible: first, a collapse of the Eurozone, second, a break with neoliberalism, and third, muddling through, in other words, continuing with existing policies.

Table 5. Employment rates, 2001-2011 (Age Group 15-64)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
EU-27	62.6	62.4	62.6	63.0	63.4	64.4	65.3	65.8	64.5	64.1	64.3
Euro area	62.1	62.3	62.6	63.1	63.6	64.6	65.5	65.9	64.5	64.1	64.2
Belgium	59.9	59.9	59.6	60.3	61.1	61.0	62.0	62.4	61.6	62.0	61.9
Bulgaria	49.7	50.6	52.5	54.2	55.8	58.6	61.7	64.0	62.6	59.7	58.5
Czech Republic	65.0	65.4	64.7	64.2	64.8	65.3	66.1	66.6	65.4	65.0	65.7
Denmark	76.2	75.9	75.1	75.5	75.9	77.4	77.0	77.9	75.3	73.3	73.1
Germany (1)	65.8	65.4	65.0	65.0	65.5	67.2	69.0	70.1	70.3	71.1	72.5
Estonia	61.0	62.0	62.9	63.0	64.4	68.1	69.4	69.8	63.5	61.0	65.1
Ireland	65.8	65.5	65.5	66.3	67.6	68.7	69.2	67.6	62.2	60.1	59.2
Greece	56.3	57.5	58.7	59.4	60.1	61.0	61.4	61.9	61.2	59.6	55.6
Spain (1)	57.8	58.5	59.8	61.1	63.3	64.8	65.6	64.3	59.8	58.6	57.7
France	62.8	63.0	63.9	63.7	63.7	63.6	64.3	64.8	64.0	63.8	63.8
Italy (2)	54.8	55.5	56.1	57.6	57.6	58.4	58.7	58.7	57.5	56.9	56.9
Cyprus	67.8	68.6	69.2	68.9	68.5	69.6	71.0	70.9	69.9	69.7	68.1
Latvia	58.6	60.4	61.8	62.3	63.3	66.3	68.3	68.6	60.9	59.3	61.8
Lithuania	57.5	59.9	61.1	61.2	62.6	63.6	64.9	64.3	60.1	57.8	60.7
Luxembourg	63.1	63.4	62.2	62.5	63.6	63.6	64.2	63.4	65.2	65.2	64.6
Hungary	56.2	56.2	57.0	56.8	56.9	57.3	57.3	56.7	55.4	55.4	55.8
Malta	54.3	54.4	54.2	54.0	53.9	53.6	54.6	55.3	55.0	56.1	57.6
Netherlands (3)	74.1	74.4	73.6	73.1	73.2	74.3	76.0	77.2	77.0	74.7	74.9
Austria (2)	68.5	68.7	68.9	67.8	68.6	70.2	71.4	72.1	71.6	71.7	72.1
Poland	53.4	51.5	51.2	51.7	52.8	54.5	57.0	59.2	59.3	59.3	59.7
Portugal (4)	69.0	68.8	68.1	67.8	67.5	67.9	67.8	68.2	66.3	65.6	64.2
Romania (5)	62.4	57.6	57.6	57.7	57.6	58.8	58.8	59.0	58.6	58.8	58.5
Slovenia	63.8	63.4	62.6	65.3	66.0	66.6	67.8	68.6	67.5	66.2	64.4
Slovakia	56.8	56.8	57.7	57.0	57.7	59.4	60.7	62.3	60.2	58.8	59.5
Finland	68.1	68.1	67.7	67.6	68.4	69.3	70.3	71.1	68.7	68.1	69.0
Sweden (1)	74.0	73.6	72.9	72.1	72.5	73.1	74.2	74.3	72.2	72.7	74.1
United Kingdom	71.4	71.4	71.5	71.7	71.7	71.6	71.5	71.5	69.9	69.5	69.5
Iceland	:	:	83.3	82.3	83.8	84.6	85.1	83.6	78.3	78.2	78.5
Norway	77.2	76.8	75.5	75.1	74.8	75.4	76.8	78.0	76.4	75.3	75.3
Switzerland (3)	79.1	78.9	77.9	77.4	77.2	77.9	78.6	79.5	79.0	78.6	79.3
Croatia	:	53.4	53.4	54.7	55.0	55.6	57.1	57.8	56.6	54.0	52.4
FYR of Macedonia	:	:	:	:	:	39.6	40.7	41.9	43.3	43.5	43.9
Turkey	:	:	:	:	:	44.6	44.6	44.9	44.3	46.3	48.4
Japan	68.8	68.2	68.4	68.7	69.3	70.0	70.7	70.7	70.0	70.1	70.3
United States	73.1	71.9	71.2	71.2	71.5	72.0	71.8	70.9	67.6	66.7	66.6

(1) Break in series, 2005.

(2) Break in series, 2004.

(3) Break in series, 2010.

(4) Break in series, 2011.

(5) Break in series, 2002.

Source: European Commission (2012): Eurostat, Statistics Explained, Brussels.
http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Employment_statistics

Table 6. Employment rates, 2001-2011 (older workers 55-64)

	Older workers (55-64)		
	2001	2006	2011
EU-27	37.7	43.5	47.4
Euro area	35.0	41.6	47.1
Belgium	25.1	32.0	38.7
Bulgaria	24.0	39.6	43.9
Czech Republic	37.1	45.2	47.6
Denmark	58.0	60.7	59.5
Germany (1)	37.9	48.1	59.9
Estonia	48.5	58.5	57.2
Ireland	46.8	53.1	50.0
Greece	38.2	42.3	39.4
Spain (1)	39.2	44.1	44.5
France	31.9	38.1	41.4
Italy (1)	28.0	32.5	37.9
Cyprus	49.1	53.6	55.2
Latvia	36.9	53.3	51.1
Lithuania	38.9	49.6	50.5
Luxembourg	25.6	33.2	39.3
Hungary	23.5	33.6	35.8
Malta	29.4	29.8	31.7
Netherlands (2)	39.6	47.7	56.1
Austria (1)	28.9	35.5	41.5
Poland	27.4	28.1	36.9
Portugal (2)	50.2	50.1	47.9
Romania (1)	48.2	41.7	40.0
Slovenia	25.5	32.6	31.2
Slovakia	22.4	33.1	41.4
Finland	45.7	54.5	57.0
Sweden (1)	66.7	69.6	72.3
United Kingdom	52.2	57.3	56.7
Iceland	:	84.3	79.2
Norway	65.9	67.4	69.6
Switzerland (2)	67.1	65.7	69.5
Croatia	:	34.3	37.1
FYR of Macedonia	:	27.9	35.4
Turkey	:	27.7	31.4
Japan	62.0	64.7	65.1
United States	58.6	61.8	60.0

(1) Break in series between 2001 and 2005.

(2) Break in series between 2006 and 2011.

Source: European Commission (2012): Eurostat, Statistics Explained, Brussels.

http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Employment_statistics

Given the weakness of the left in Europe, the prospect of a break with neoliberalism can probably be excluded; but neither is the Eurozone likely to fall apart, so we may assume that the current conservative-liberal policies will continue to be applied.

On this current path of muddling through, political leaders will focus on avoiding immediate collapse, especially via European Central Bank interventions meant to reassure financial markets and continue on their austerity course for the real economy. The recession in the Eurozone in 2012, caused by austerity, is likely to continue in 2013, due to further cuts and the downturn in the global economy (the US crisis, problems in emerging economies and so on). If the many pitfalls that could lead to a collapse of the Eurozone are avoided, the budgets of the southern European countries may achieve consolidation from 2014–2015 and a new phase of economic growth in southern Europe may open up, based on low interest rates, greater competitiveness and cleaned-up budgets.

In this scenario, the stabilisation of financial markets will be combined with a recession in the real economy in 2012 and 2013. However, the fact remains that we are currently walking a tightrope and the reasons why the current approach may fail are many. Nonetheless, if economic, social and political obstacles are overcome, stability could be achieved from 2014–2015. Public budgets for the countries of southern Europe may, by then, be healthy enough to end the strangulation induced by the austerity drive; their international competitiveness will also probably have increased by then, due to the drastic fall in real wages; and finally, low interest rates for medium- and long-term loans could act as a major incentive for investment.

A lengthy austerity period – which could well last about five years – would have a devas-

tating impact on the European social model. The exhortation to “save, save, save!” would simply deepen the recession and increase unemployment further, resulting, in turn, in lower real wages and weakened unions. It would also lead to further cuts in education, health, pensions and employment measures.

Institutional Conditions: Neoliberal Streamlining

The prevailing austerity drive was consolidated in 2011 and 2012 by a series of institutional changes at the EU level: reforms to the Stability and Growth Pact as reinforced by the Six Pack, procedures to avoid macroeconomic imbalances, the Fiscal Compact and the Euro Plus Pact.

Proposals by the European Commission and by the Rompuy working group on economic and monetary union, discussed at the last two summits of heads of state and governments held in 2012, were evidence of further neoliberal institutional streamlining measures, likely to continue in 2013–2014.

These proposals provide for ex-ante control of the budgets of member states, given that ex-post intervention in member state policies – through the Six Pack, procedures aimed at avoiding macroeconomic imbalances and the Fiscal Compact – is no longer considered sufficient. The European Commission would have the power to reject draft budgets presented to national parliaments and even to amend budgets after approval by national parliaments. Furthermore, member countries with debt and competitiveness problems would be obliged to enter into binding agreements with the European Commission by which they would undertake to reverse policies, for example, wage and social policies. The willingness of member countries to accept such “submission agreements”

will undoubtedly increase in line with the availability of funds from the EU budget.

The implementation of such policies would be disastrous for the future of the European social model: under the neoliberal excuse of improving competitiveness, the welfare state would be dismantled and the unions muzzled. And unions would not be the only losers of

“successful” implementation of conservative-liberal recipes, as social democratic and socialist parties would also have lost the ideological battle over which policies should have been applied to overcome the crisis. The political and institutional implications of such a defeat are not as yet visible, but the omens for the European left are not good.

The Economic and Debt Crises

A New European Economic Governance Structure with Major Shortcomings

Björn Hacker

Introduction

The crisis in the Eurozone is far from over. We are about to enter its fourth year and the signs that might indicate future developments are all but clear concerning whether Europe will be able to get out of this crisis soon. Since its beginning with Greece's refinancing problems on the financial markets, we have seen the emergence of a multiplicity of crises: Is it a liquidity crisis or a sovereign debt crisis? Or even a currency crisis? An institutional crisis? It is certainly an economic crisis, but is it also a social and political crisis? These different forms of crisis overlap and form a complicated construction, difficult to understand even for experts. Politicians, as well as economists and social scientists resemble a group of people fumbling around in the dark without finding the right door to escape. Nevertheless, in the last three years of crisis management a lot of doors have been

opened, implementing many new instruments and institutional settings. Some have been very helpful in taking the first steps to overcome the crisis, such as the rescue packages and the establishment of the EFSF and the ESM. Others died on the vine, such as the idea of leveraging the EFSF. And some new instruments had a counterproductive effect on the crisis, such as the private sector haircut in Greece in 2011, destroying market confidence and bringing Spain and Italy into troubled water, or too harsh austerity measures, leading countries into severe recession instead of enabling urgently needed economic growth.

However, the main exit door out of the crisis has not yet been found and the December 2012 summit showed how unlikely it is that a compromise will be found to take the necessary steps in political integration, to complete the existing monetary union with a full-fledged fiscal and political union in order to correct the

main construction deficits of the Maastricht Treaty. In fact, we are circling around the same problems that should have been obvious already in 1992. But politicians do not like to admit the constitutional shortfalls of the Eurozone. As a matter of fact, the dominant crisis management for three years now has concentrated on strengthening the fiscal discipline of the Member States. In the absence of the political will and unanimity for a general revision of the basis on which the monetary union functions, the focus was put on a fine-tuning of the existing elements of European economic governance. Here, we shall present an overview of and evaluate the main aspects of the economic governance tools implemented and discussed in 2012.

A Closer Look: Content of New Governance Rules – Packs and Pacts

Rules and Regulations prior to 2012

With the Maastricht Treaty, Europe created its own currency. The irreversible fixing of exchange rates and the transfer of monetary policy to the European Central Bank (ECB) in 1999 are the cornerstones on the way to the euro, which became the legal tender in 12 EU Member States in 2002. Nowadays, the Eurozone consists of 17 Member States and is based on two main components: on one hand, monetary policy and responsibility lies solely in the hands of the ECB, while on the other hand economic and budgetary policies are conducted by the Member States and monitored by the European Commission. With regard to the latter, the Member States coordinate their economic policies in the Broad Economic Guidelines, adopted by the Council in the form of a non-legally binding recommendation, and they commit themselves to meeting

the criteria of the Stability and Growth Pact (SGP). If the Commission considers that a Member State's deficit breaches the 3 per cent of Gross Domestic Product (GDP) threshold of the Treaty, the Council can issue recommendations. If they are not taken into account by the Member State, the Council may decide to impose sanctions.

To bridge the gap between EU competencies and Member State autonomy in economic policymaking, the Lisbon Process started in 2000 as a ten year growth strategy. Its core was the soft coordination of all kinds of economic, employment and social policies. The Member States agreed on specific objectives in the various policy fields and a set of benchmarks and indicators with which progress was monitored by the Commission and the Council. The same principles are valid for the succeeding Europe 2020 strategy, which started in 2010, although this strategy is concentrated on five common objectives: under the headline of promoting 'smart, sustainable and inclusive growth', quantitative goals are defined in employment rates, expenditure on research and development, climate protection and energy consumption, education policy and social inclusion. Altogether, ten economic and employment policy guidelines were formulated. The Europe 2020 strategy thus stands in stark contrast to the Lisbon Strategy's 24 guidelines.

Along with the new growth strategy in 2010 a new EU level policy coordination tool was introduced: the European Semester. It enables the EU to bring together two formally independent governance streams: the fiscal surveillance under the Stability and Growth Pact and the economic surveillance and thematic coordination under the Europe 2020 Integrated Guidelines. The European Semester starts annually with a growth report by the Commission which sets

out the macroeconomic development of the EU and identifies the challenges ahead. On this basis, the ECOFIN Council issues its first policy recommendations in March. The following month, the Member States are requested to submit their Stability and Convergence Programmes, as well as their National Reform Programmes to Brussels. The June Council evaluates these Programmes and submits country-specific recommendations. In the second half of the year, the Member States are supposed to transpose the EU's recommendations into national policy.

In 2011, the March summit implemented the Euro-Plus Pact, an intergovernmental Franco-German initiative, signed by all Euro-Member States, as well as Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania. The pact was intended to foster competitiveness and to strengthen fiscal strength. The participating Member States agreed on strengthening the economic governance of the EU by following common principles, concentrating on actions with regard to which competence lies with the Member States. It is recommended to review wage setting arrangements and indexation mechanisms, to foster employment by labour market flexibilisation and lowering taxes on labour, by aligning the pension system to the national demographic situation and by translating EU fiscal rules as set out in the Stability and Growth Pact into national legislation, for example, by financial debt brakes.

The Six-Pack: Strengthening of the Stability and Growth Pact

After a long period of inter-institutional discussions and amendments, the so-called Six-Pack, a new set of rules for economic and fiscal surveillance, entered into force on 13 December

2011. It consists of five regulations and one directive and is aimed at strengthening the Stability and Growth Pact. Its components are as follows:

- A preventive arm with a country-specific medium-term objective (MTO), on which the Member States' budgetary balances shall converge.
- A corrective arm, in which the public debt level objective of 60 per cent of GDP will receive the same attention as the 3 per cent budget deficit target. If a country is not respecting this benchmark, a deficit procedure will be opened, even if the Member State has a budget deficit below 3 per cent. A gap between its debt level and the 60 per cent reference needs to be reduced by 1/20th annually (on average over three years).
- The excessive deficit procedure (EDP) is implemented with different levels of surveillance and sanctions up to a fine of 0.5 per cent of GDP. Most sanctions can be adopted by reverse qualified majority voting, meaning that a financial sanction can be imposed by the Council on the basis of a Commission recommendation, unless a qualified majority of Member States votes against it.
- Completely new is the Macroeconomic Imbalance Procedure (MIP). This is an alert system that uses a scoreboard of indicators in order to observe and prevent the occurrence of large current account imbalances between the Member States. The indicators of the Scoreboard contain, for example, the development of national investments, unit labour costs, private sector debt or the unemployment rate. Violation of certain thresholds also leads to EIP. A three year backward moving average of the current account balance as a percentage of GDP, with thresholds of a current account surplus of

maximum +6 per cent of GDP and a current account deficit of maximum –4 per cent of GDP, are allowed. A violation of the benchmarks defined in the Scoreboard can trigger an EDP as well.

In total, the existing structure of the SGP is strengthened with a new focus on public debt levels besides the 3 per cent annual deficit criterion, simplified decision-making modes for deficit procedures and an ex ante governance mechanism for deficits and macroeconomic imbalances.

The Fiscal Compact: Intergovernmental Approach for Stronger Surveillance

Originally named a ‘competitiveness pact’, the ‘Treaty on Stability, Coordination and Governance in the Economic and Monetary Union’, more plainly named the ‘Fiscal Compact’, was signed in March 2012 as a new intergovernmental treaty. This treaty stands outside general EU legislation and is signed by 25 Member States of the EU (the United Kingdom and the Czech Republic are not participating). It is only binding for Members of the Eurozone, while others are invited to meet the criteria. The Fiscal Compact entered into force on 1 January 2013, after the minimum of twelve Contracting Parties whose currency is the euro ratified it. The States that have ratified the Fiscal Compact are Austria, Cyprus, Germany, Denmark, Estonia, Spain, France, Greece, Italy, Ireland, Lithuania, Latvia, Portugal, Romania, Finland and Slovenia. Within five years, the treaty shall be incorporated into the legal framework of the EU.

At least twice a year a special summit of the Heads of States belonging to the Eurozone shall reflect on economic governance issues with the Presidents of the Commission and the ECB. The

main part of the Treaty is made up of regulations for the national public budgets, which shall in principle be balanced or in surplus (‘balanced budget rule’). The lower limit of the annual structural deficit (without cyclical effects) should not exceed 0.5 per cent of GDP. At the latest one year after being in force, a debt brake rule shall be implemented in the national legislation of the participating countries, preferably in constitutional law. This refers to the debt brake already established by the Six-Pack (see above): a country with a deficit-to-GDP-ratio higher than 60 per cent is obliged to reduce its public debt by 1/20 annually on the basis of a three year average.

If national implementation is not enacted in time or the balanced budget rule not fulfilled, the European Court of Justice (ECJ) may decide on financial sanctions against the Member State, such as a deposit guarantee up to a fine of 0.1 per cent of its GDP. The Fiscal Compact refers to the Six-Pack and strengthens some of its elements, for example that all stages of the EDP, the proposals of the Commission and the recommendations of the Council will be enacted, unless a qualified majority of the Member States votes against it.

The Two-Pack: More Surveillance in the Making

The so-called Two-Pack, based on two regulations proposed by the Commission, is built on the Six-Pack and aimed at improving the ex ante fiscal monitoring and ex post surveillance:

- Member States should be obliged to send their draft budgetary plans for the following year to the Commission, even before they are adopted in the respective national parliament. If these draft budget plans are not in line with the rules and recommendations of

the SGP and the European Semester, the Commission can require a revised draft budgetary plan.

- Member States with severe financial difficulties – for example, in need of or already receiving financial assistance by the EFSF or the ESM – shall automatically fall under enhanced fiscal and economic surveillance. This should involve review missions and quarterly reporting by the Commission, an obligation to adopt certain measures to tackle instabilities, as well as a procedure for deciding on and monitoring a macroeconomic adjustment programme. If the Member State does not comply with this programme, the Council may decide on financial consequences.

Although the Commission and the Council tried to push the implementation of these two regulations several times throughout 2012, the Two-Pack is still under discussion between both institutions and the European Parliament. This is because the latter has announced some criticisms of the original plans. MEPs stress the need for putting growth enhancing measures on the agenda instead of pulling further in the direction of spending cuts. They fear that the envisaged budget cuts would lower investment for economic growth and harm important state sectors, such as social security and education. As an alternative, the European Parliament proposes the implementation of a European Redemption Fund, where to all Member State's debt over the 60 per cent GDP threshold should be transferred and liquidated by a common European bond. While the Parliament amends the original Commission's proposal by demanding limits on the Commission's power in monitoring national budget plans, it is in favour of greater use of the 'reversed qualified majority' instrument in the Council concerning fiscal surveil-

lance. The negotiations could not be finished in 2012.

Roadmaps and Blueprints: For a 'Genuine' Economic and Monetary Union

In June 2012 the European Council invited its President, Herman van Rompuy, 'to develop, in close collaboration with the President of the Commission, the President of the Eurogroup and the President of the ECB, a specific and time-bound road map for the achievement of a genuine Economic and Monetary Union', after this group has proposed to the Council four main building blocks on the future of EMU governance. These building blocks represent – in the eyes of the four presidents – the missing pieces of a complete monetary union architecture:

- an integrated financial framework;
- an integrated budgetary framework;
- an integrated economic policy framework;
- the strengthening of democratic legitimacy and accountability.

After presenting an interim report at the October summit, the final version of the van Rompuy report was submitted prior to the December European Council. It proposes a three-stage sequencing, with the following main components:

- In stage 1 until the end of 2013 the main components of the planned Banking Union shall be implemented: a single supervisory mechanism and the operational framework for direct bank recapitalisation through the ESM.
- In stage 2 from 2013 until 2014 the banking union shall be completed by setting up a common resolution authority for financial institutions and a new idea, namely direct contractual agreements between the single

Member States and the European institutions will be launched: States shall receive temporary financial support out of a new common budget if they commit themselves to structural reforms.

- In stage 3 after 2014 a new fiscal capacity to absorb country-specific economic shocks shall be introduced and function as an insurance system. Furthermore, Member States' taxation and employment policies shall be more strongly coordinated.

The van Rompuy proposal was not the only report rendered on the future of the monetary union. At the end of November 2012 the European Parliament and the European Commission adopted their own plans. The resolution of the Parliament of 20 November – adopted by a huge majority – calls for a leap towards a federal Europe. The deputies criticised the fact that the President of the Parliament was not invited to attend the meetings of the van Rompuy group and demanded stronger accountability and more rights of control and consultation. It demands better inclusion of the national parliaments if more rights are transferred to the European level. As part of a Fiscal Union the resolution proposes a gradual rollover of excessive debt into a redemption fund and lists very detailed objectives for a 'Social Pact for Europe', for example, a European youth guarantee to tackle youth unemployment and the implementation of a social protocol to protect fundamental social and labour rights.

On 28 November the Commission published a 'Blueprint for a deep and genuine Economic and Monetary Union', proposing short-, medium- and long-term steps for better European governance. As in the van Rompuy report, a new fiscal capacity to balance economic heterogeneities is proposed, labelled the 'convergence and competitiveness instrument'. For Member

States of the Eurozone, contractual agreements with the European institutions on the basis of the Scoreboard indicators introduced with the Six-Pack shall be implemented as parts of a system of financial incentives. Contrary to the van Rompuy report, these measures are presented as very urgent. In a mid-term perspective, the Commission calls for the introduction of a redemption fund and Eurobills and in the longer time frame for Eurobonds and a common Eurozone budget with the possibility to raise taxes at Community level.

Contrary to the far-reaching ideas on the table for revision and completion of the monetary union, on 13 and 14 December the European Council took notice of all these reports but resolved none of them. Instead, the Heads of States focused on the finalisation of the Banking Union with concrete steps in 2013 and asked van Rompuy to work together with the President of the Commission on a roadmap of the issues of economic coordination, the social dimension of the EMU, the practicability of individual contracts between the Member States and the EU for Eurozone members and solidarity mechanisms. This roadmap shall be presented and discussed at the June 2013 summit.

A Step Forward or Back? An Evaluation of the New Economic Governance Rules

The above-listed set of new instruments and discussed ideas and plans shows how much European economic governance has developed in the past year. However, not all of the implemented measures help to overcome the crisis. In this section, their possible impact shall be evaluated by showing the overall direction of the reforms on an aggregated level and by pointing to some potential dangers.

The Focus on Fiscal Discipline Fails to Heed the Origins of the Euro Crisis

No doubt, the year 2012 saw some important steps in the economic governance system of the Eurozone. It was the first year in which the long-discussed Six-Pack was applied with all its components within the framework of the European Semester. Furthermore, the Fiscal Compact, a new intergovernmental treaty, was signed and there was some progress regarding the Two-Pack legislation. Finally, at the end of the year we saw a number of concept papers on the future of the monetary union.

The main objective of most of these reform elements is to strengthen the fiscal discipline of the Member States. The existing Stability and Growth Pact was reinforced and the Commission and the Council are now able to react much more quickly – in a preventive and corrective way – on deviations by starting an excessive deficit procedure. The surveillance of the Member States to keep their budgets in line with the defined medium-term objective increased and breaking the rules of the SGP now leads to a quasi-automatic sanctions procedure with different levels that are hard to avoid for the affected country. The strengthening of the common budget rules is, to be sure, an important objective in a monetary union, in which the monetary policy is centralised but fiscal policies are still in the hands of the Member States. This approach is nevertheless an inadequate answer to the origins of the crisis in the Eurozone.

Reforms for more surveillance and fiscal discipline are justified by the high indebtedness of many Member States. Of course, if one looks at the general budget balance in 2011, only Germany, Estonia, Luxemburg, Malta, Austria and Finland – six States out of 17 – are in line with the 3 per cent deficit target. The same is true for

the general government debt. In 2011, only Estonia, Luxemburg, Slovenia, Slovakia and Finland – five States out of 17 – were below the threshold of 60 per cent; the Eurozone as a whole has an average debt level of 88.1 per cent of GDP. Greece skyrockets beyond all others, with a government debt level of 171 per cent (Euro area key indicators, European Commission). This country never properly met the Maastricht Criteria for joining the Eurozone and is constantly breaking the Stability and Growth Pact. But is this example the origin of the crisis we are facing today? The answer is no. It is a myth that the crisis is caused by too high indebtedness among the Eurozone countries. It is not possible to simply apply the Greek scenario to other countries in crisis. Spain and Ireland never violated the SGP until 2008! Most of the sovereign debt we bemoan today was due to bank rescue plans and economic stimulus packages in the wake of the global financial and economic crisis. Member State budget deficits in the Eurozone were, on average, –4.1 per cent in 2011, –6.2 per cent in 2010 and –6.3 per cent in 2009 – far beyond the Stability and Growth Pact objective. But before the global crisis and its aftermaths, the average was, at –2.1 per cent in 2008 and only –0.7 per cent in 2007, absolutely in line with the Stability and Growth Pact objectives. Furthermore, the general debt level in 2007 was relatively low, at an average of 66.4 per cent of GDP in the Eurozone. At the time, the countries now in crisis, Ireland and Spain, even ran budget surpluses, which at times reached more than 2 per cent of GDP and they had low debt to GDP ratios, with 36 per cent in Spain and 25 per cent in Ireland (Eurostat Data).

Considering this data, it is odd to declare that the Member States have been too lax with their budget policies and that the Stability and Growth Pact was toothless. Prior to the global

crisis and despite violations by some Member States – such as Greece since the start of EMU, but also Germany and France, which violated the budget rule in 2002–2004/2005 – the SGP fulfilled its function.

More crucial for the existence of the crisis in the Eurozone is the evolution of huge macroeconomic imbalances. They can be ascribed to a large extent to a common key interest rate that did not fit the economic situation of most countries, while corrective transfer mechanisms to fight asymmetric shocks do not exist. Already before the crisis Portugal, Spain, Greece, Ireland and Italy accumulated high current account deficits. Behind this stood a rapidly rising private sector debt, caused by a credit-financed consumption boom with the emergence of bubbles and combined with a loss in price competitiveness. In contrast, Germany, Austria, Finland and the Netherlands run high current account surpluses. Due to years of wage restraint, these countries export relatively cheap goods and capital to their European neighbours. The problem is that debtor and creditor countries are sitting in the same boat: if a State steps out by default, the borrowing country will lose its foreign assets and possibly parts of its export market.

As uncontrolled private sector lending and borrowing is the major problem behind the crisis in the Eurozone, strengthening the fiscal discipline framework is not very helpful. Against this background, only the macroeconomic surveillance procedure as part of the Six-Pack is a step in the right direction. However, the prevention of macroeconomic imbalances is not seen as a symmetrical task for EU countries: current account deficits are allowed up to a threshold of –4 per cent of GDP and current account surpluses up to +6 per cent of GDP, as defined in the Scoreboard. The adjustment therefore lies asymmetrically on the deficit countries.

Austerity Pressure on the Welfare States Is Burying the European Social Model

The new European governance architecture, with its central European Semester mechanism of coordination, reporting and monitoring in economic, budgetary, employment, social and many other policies, enables the EU to better organise decentralised policies by means of common targets and rules. But as progress in the field of European *social* governance is fairly modest, most of the new instruments belong to the *economic* governance area. As mentioned above, the majority of the new rules are set in order to strengthen fiscal discipline. It is obvious that all other policy areas will be subordinated to meet this objective. Already the integrated approach of combining the Europe 2020 Strategy targets with the Stability and Growth Pact rules in the European Semester opened the door for cross-thematic references in the recommendations for the Member States. Now, with tightened budget discipline, the likelihood is even greater that the Commission and the Council will voice objections to unsuitable national budgetary policies with reference to particular employment and social policies. That means that if the strengthened Stability and Growth Pact rules are not fulfilled, the Commission and the Council will demand structural reforms from the Welfare State concerned.

The crisis proves that the constitutional asymmetric design of European integration is frozen: the market-creating mechanisms for enabling free trade of goods, people, capital and services are dominant and the market-shaping and market-correcting mechanisms lag far behind. In EU legislation for years no further step has been taken to strengthen the social dimension of the EU:

- the equal prominence of social rights and economic freedoms in the form of a social clause in all EU legislation is still missing;
- the Europe 2020 Strategy focuses on employment rates and poverty reduction instead of setting common social standards;
- the one-size-fits-all approach of the Open Method of Coordination does not take into account different Welfare State pathways and singularities;
- intra-European competition for investments, jobs and production sites is encouraged, but there are no common rules for minimum wages, social spending and harmonised cooperation taxes, which would be needed in the form of a 'European Social Stability Pact';
- the non-binding 'Compact for Growth and Jobs', concluded by the Heads of State at their June 2012 summit, argues for structural reforms and a deepening of the single market, as well as for implementing project bonds and better use of the European Investment Bank instead of starting a European New Deal programme of employment and social investment.

Since the EMU was founded, national Welfare States have experienced difficulties in following their own paths in some economic and social policy areas. We have seen competition between different wage, tax and social spending models in the past 13 years, based primarily on economic, not social policy considerations. Now, with the new framework of economic governance and the streamlining process in the European Semester, we shall move from free competition around the question of which Welfare State Model adapts best to the economic integration scheme, to a sort of codification of the right path at supranational level, forcing all Member States to follow.

An obvious example is the austerity course being pursued in the crisis. The adjustment

measures for Greece, Portugal and Ireland, but also the recommendations for Spain and Italy to cut social spending, lower wages and pensions and flexibilise the labour market, are dismantling the Welfare State. From a northern European perspective this is nothing new, but in these countries, trade unions and other veto players defended against major cuts for a long time – and these singularities are now over. Another important single policy example is the pensions sector. Of course, social policy remains in the hands of the Member States, but the EU now has a governance framework in which claims to shape old-age policies in the Welfare States can be raised. A glance at the Commission's green and white books on pensions shows the argumentative line: portability of pension entitlements is necessarily an issue of the single market. And the high financing costs of pensions are an issue for financial sustainability in EMU. The expected recommendations in the field of pensions will therefore rely lopsidedly on financial sustainability and not on the adequacy of pension entitlements.

Constantly, we are moving towards an even more liberal European Social Model. What we are losing at national level in terms of competence to shape our welfare states is not given back to us at supranational level by the new European economic governance structure.

Intergovernmental Decision-making Risks Harming Democratic Legitimacy in the EU

The year 2012 showed the limits of cooperation and mutual advancement in European economic governance. The fiscal compact's layout and philosophy was not shared by all Member States and took the form of an intergovern-

mental treaty outside general EU legislation. It is important to note that most of the new governance tools are created for the members of the Eurozone, not all 27 EU Member States. Constantly, the monetary union moves on towards a hard integration core, leaving other countries behind. This might in the near future create new tensions as some States, such as Poland, will not agree with many aspects of a *two-tier* Europe.

Notwithstanding the urgent need for stronger economic coordination inside EMU and not considering its adverse contents, evaluated above, the path chosen with the Euro-Plus Pact in 2011 and the Fiscal Compact in 2012 is a purely intergovernmental one. This creates new problems because the European Parliament is marginalised in its co-decision options, the Commission is degraded to a general secretariat of the Council and the national parliaments are put under pressure to let pass any new governance plan made by the Heads of State with reference to urgent crisis solutions as the one and only alternative.

What would be needed to enhance economic governance processes is a strengthening of the parliamentary decision-making on European issues via more competences for the European Parliament and a significant increase in the Europeanisation of national parliaments, as well as new and better forms of interparliamentary cooperation in the EU. It has to be decided whether the European integration process shall at least temporarily take a *two-speed* form, with the Eurozone-17 developing one step more quickly than the EU27. Interesting ideas on a Parliament for the euro inside the European Parliament and new transnational parliamentary committees and a powerful commissioner on Eurozone issues are already being discussed.

Shortcomings and New Risks: Why We Urgently Need an Alternative Governance Approach

The year 2012 showed some progress in defining a new European economic governance structure, albeit with three major shortcomings:

1. the reform approach is based solely on fiscal discipline and asymmetric adjustment due to a false perception of the origins of the crisis in the Eurozone;
2. national welfare states will be further dismantled by this strategy and no attention is being paid to strengthening the social dimension of the EU;
3. the decision-making mode of the new governance instruments functions increasingly in an intergovernmental way, thereby harming democratic legitimacy.

What would urgently be needed to get out of the crisis soon and to improve the functionality of EMU is common debt management in the form of a redemption fund and eurobills/eurobonds; a symmetric adjustment strategy with regard to the macroeconomic imbalances in the Eurozone; and a new mandate for the European Central Bank to take into account not only price stability, but also nominal economic growth. Amendments of the European Parliament on the Two-Pack legislation pick up some of these ideas.

Furthermore, the austerity course has to be stopped. Structural reforms are necessary in the states in crisis, but it would be more helpful if these reforms concentrated much more sharply on increasing tax bases and tax collection and on modernising and simplifying administrative machineries instead of savagely cutting wages and social spending. The basic problem with the austerity course is that Greece, Portugal, Ireland, Spain and Italy are caught in a trap of

recession and debt. Through the fiscal multiplier the lower consumption and decreasing economic activity caused by the spending cuts and growing unemployment lead to lower taxes and an even higher public debt. Without progress towards a solidarity-based European Social Model, the crisis will not be solved and welfare states will be further dismantled. Therefore, the social and growth dimension of EU governance reforms needs to be pushed, for example by setting up a European Social Stability Pact and a European New Deal Programme.

More obviously than ever before, events in 2012 urged all political actors to rethink the political architecture of the EU. Many of the new governance instruments are needed for the Eurozone members only, which creates new problems with the established institutional decision-making modes. The dominance of an intergovernmental crisis management modus needs urgently be replaced by adequate involvement and strengthening of the competences of the European Parliament, as well as the national parliaments in order to strengthen democratic legitimacy. Furthermore, European political actors should not shy away from posing the important question of whether the future integration process will move towards two-tier or two-speed integration. To prevent disintegration, different speeds of integration – with EMU advancing one step more quickly than EU Members as a whole, but keeping the door open for the others to join – would be the better choice.

The development of European economic governance in 2012 was dominated by a con-

tinuing false analysis of the crisis in the Eurozone and the implementation of partly counterproductive instruments and mechanisms. The stubborn austerity course leads many States directly into a vicious circle of debt and recession; reinforces the burial of the European Social Model by dismantling the Welfare State to an unprecedented extent; and creates growing problems of democratic legitimacy in exchange for a kind of permanent 'Congress of Vienna' in the form of endless crisis summits. It is primarily the Merkel administration in Germany which is to blame for the dominant crisis strategy and, as a consequence, for the problems we are facing, which will be exacerbated in 2013. The plans of French President François Hollande to change the course of German Chancellor Angela Merkel by implementing eurobonds and a new growth and investment strategy ended suddenly at the June 2012 summit with the rather low-impact project bonds and support for an increasing role of the European Investment Bank. Clearly, this is not enough to correct the shortcomings of the implemented governance tools.

In the roadmaps, blueprints and reports for a 'genuine' EMU we read at the end of the year some interesting proposals are made which point to an alternative policy attempt to tackle the crisis and complete the monetary union by a fiscal and political union. However, the December 2012 European Council did not make any decisions and postponed a clear statement on economic governance issues until the June 2013 summit. Let us see if political leaders will find the courage to make the big leap.

Economic Policy in the Eurozone: Austerity versus Growth and Solutions for the Crisis

Manuel de la Rocha Vázquez, Miguel Ángel García Díaz, Domènec Ruiz Devesa

Economic Developments in the Eurozone in 2012

The contraction in economic activity in the European Union's (EU) peripheral countries in the last quarter of 2011 has spread to most of the Eurozone (including the core countries), now officially in recession. Annual gross domestic product (GDP) in 2012 was due to contract by -0.4 per cent,¹ in the second period of negative growth since the onset of the crisis; the first was in 2009, when growth shrank by -4.1 per cent. The overall GDP estimate for the Eurozone in 2012 reflects wide differences between countries; activity levels in Greece, Portugal, Spain, Italy and Slovenia continue to plummet, while the rest of the EU has

had to content itself with a modest annual growth rate of under 1 per cent (**Table 1**).

In these adverse conditions, unemployment continues to grow (rising from 10.2 per cent of the active population in 2011 to 11.3 per cent in 2012 and now affecting around 18 million people in the EU). Unemployment is also unequally distributed in the Eurozone. The negative trends of recent years in Spain, Greece, Portugal, Italy, Slovenia and Cyprus continue; countries such as Holland, France, Austria, Finland, Belgium, Malta and Luxemburg are continuing to see an upward, albeit less dramatic, trend in unemployment; and only Germany and Estonia are witnessing a fall in unemployment. Since the onset of the crisis, some six million people in the Eurozone have joined the ranks of the unemployed (**Figure 1**).

¹ European Commission autumn forecast for 2012.

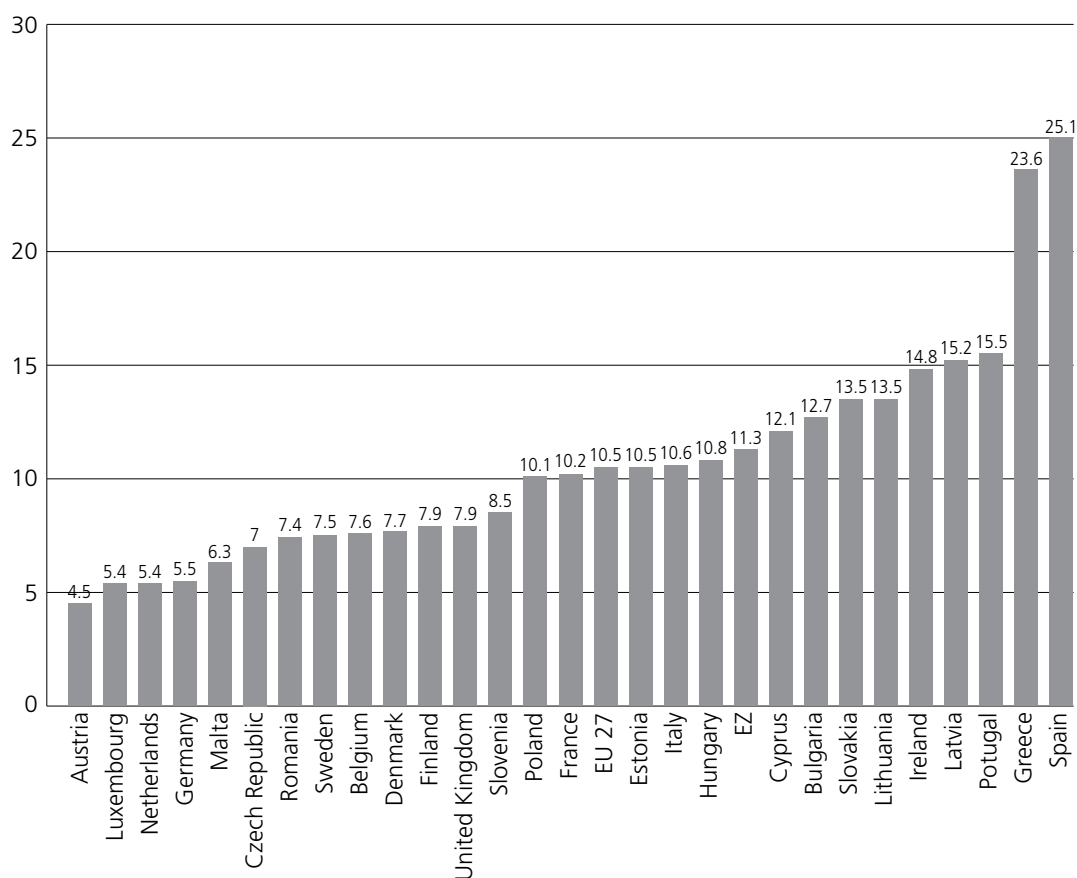
Table 1. GDP growth [% change over the previous year]

	2005	2006	2007	2008	2009	2010	2011	2012 forecast
EU-27	2.0	3.2	3.0	0.5	-4.2	1.8	1.5	0.0
Eurozone	1.7	3.0	2.8	0.4	-4.1	1.8	1.4	-0.3
Belgium	1.8	3.0	2.8	1.0	-3.1	2.1	1.9	-0.1
Austria	2.9	3.4	3.1	2.0	-3.6	2.0	3.1	0.7
Bulgaria	6.2	6.3	6.2	6.0	-4.8	0.2	1.8	1.4
Cyprus	3.9	4.1	4.4	3.7	-1.7	1.0	0.5	-0.5
Czech Rep	6.3	6.8	6.0	2.5	-4.8	2.4	1.7	0.0
Denmark	2.4	3.3	1.6	-1.2	-4.9	2.1	1.0	1.1
Estonia	9.2	10.4	6.3	-3.6	-14.0	3.1	7.5	1.2
Finland	2.8	4.9	4.2	1.0	-7.8	3.1	2.7	0.8
France	1.9	2.2	2.2	0.4	-2.2	1.6	1.7	0.4
Germany	0.8	3.0	2.5	1.3	-5.1	3.7	3.0	0.6
Greece	2.9	4.5	4.0	2.0	-2.0	-4.5	-6.8	-4.4
Hungary	4.0	4.1	1.1	0.6	-6.3	1.2	1.7	-0.1
Ireland	6.4	5.7	6.0	-2.3	-9.0	-1.0	0.9	0.5
Italy	0.7	2.0	1.6	-1.0	-5.0	1.3	0.2	-1.3
Latvia	10.6	12.2	10.0	-4.6	-18.0	-0.3	2.3	2.1
Lithuania	7.8	7.8	8.9	3.0	-15.0	1.3	5.8	2.3
Luxembourg	5.2	6.4	5.2	0.0	-3.4	3.5	1.1	0.7
Malta	3.2	3.4	3.6	2.0	-1.9	3.7	2.1	1.0
Netherlands	1.5	3.0	3.5	2.1	-4.0	1.8	1.2	-0.9
Poland	3.6	6.2	6.6	5.0	1.7	3.8	4.3	2.5
Portugal	0.9	1.4	1.9	0.0	-2.7	1.3	-1.5	-3.3
Romania	4.2	7.9	6.2	6.2	-7.1	-1.3	2.5	1.6
Slovakia	6.6	8.5	10.4	6.4	-5.8	4.0	3.3	1.2
Slovenia	4.3	5.9	6.8	3.5	-7.4	1.2	0.3	-0.1
Spain	3.6	3.9	3.7	0.9	-3.7	-0.1	0.7	-1.7
Sweden	3.3	4.2	2.6	-0.2	-4.9	5.5	4.2	0.7
UK	2.2	2.8	2.7	-0.1	-4.9	1.3	0.9	0.6
Switzerland	3.1	2.7	1.9	0.0	-2.6	3.0	1.7	2.1
USA	1.9	2.0	2.4	-1.2	-6.3	4.4	-0.7	2.0
Japan								

Source: Eurostat.

The economic slowdown, combined with high unemployment, sets the scene for a rise in outstanding sovereign debt due to the impact of built-in stabilisers on revenue and expenditure. A forecast improvement in public finances for 2012 (-0.8 GDP percentage points) situated the EU average deficit close to the objective set by the EU authorities (-3.2 per cent of GDP), with notable differences between countries (**Figure 2**).

Despite progress with fiscal consolidation, outstanding public debt for the Eurozone in 2012 is anticipated to have risen by 4.8 percentage points to 92.9 per cent of GDP. However, this average conceals great differences between countries (**Figure 3**). This level of debt is very similar to that of the United Kingdom (88.7 per cent of GDP), but is lower than that of the United States (106.9 per cent of GDP) and, most especially, that of Japan (235.8 per cent of GDP).



Source: Eurostat.

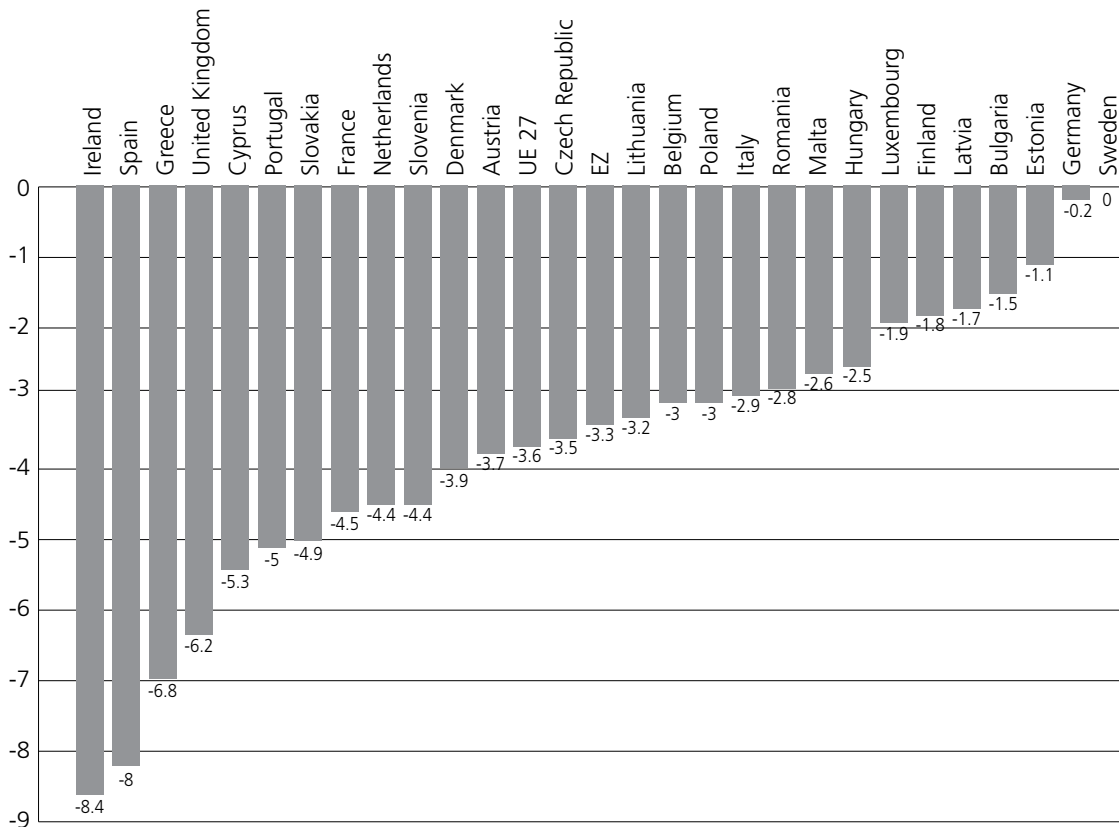
Figure 1. Unemployment as a share of the active population in 2012

The increase in sovereign debt is not affecting all member states in the same way, as financial market access and costs are different. The benchmark for calculating the risk premia of other countries is Germany, which has a very low nominal interest rate on 10-year bonds (1.3 per cent) – effectively negative when inflation (-0.7 per cent) is taken into account. The most unfavourable spreads are those for Greece (27.8 per cent), Portugal (10.5 per cent) and Ireland (7.1 per cent), countries that are practically frozen out of the financial markets. In their wake, Spain and Italy are also in a costly and complicated situation (5.9 per cent and 5.2 per cent,

respectively). The climate of uncertainty in the capital markets is a constant threat hovering over the entire Eurozone.

Growing Structural Imbalances - Balance of Payments

The low level of economic activity in 2012 went hand-in-hand with a slight surplus in the balance of payments for the EU and the Eurozone (0.4 per cent and 1.1 per cent of GDP, respectively). However, this overall equilibrium conceals considerable differences between member



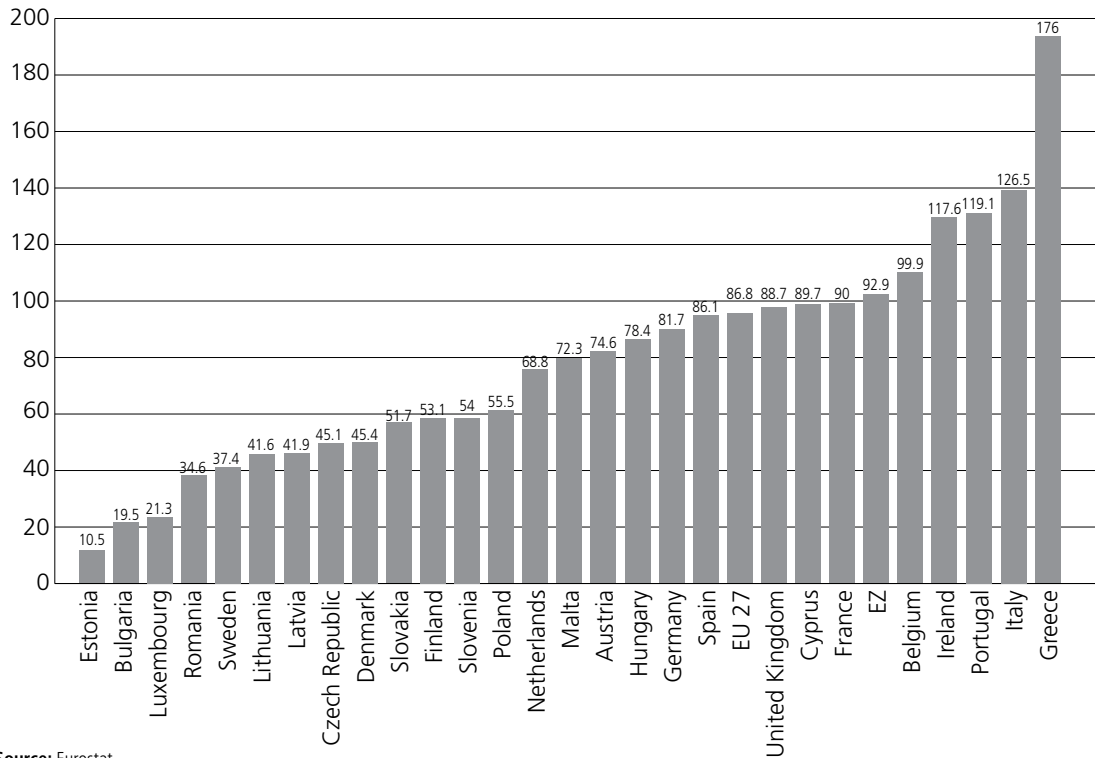
Source: Eurostat.

Figure 2. EU: Annual public account balances in 2012 as a proportion of GDP

states. Specifically, the data point to a clear dichotomy between creditor and debtor countries, with funds flowing from the former to the latter and generating a debt to be repaid in the future. This is particularly evident for Spain and Portugal as, despite weak domestic demand, their current account balances will remain negative, due to high interest payments on debt acquired abroad during the boom years. To this burden on their current revenues must be added the principal to be returned when the debt matures.

Nonetheless, the evolution of current account balances clearly shows an improvement

in the external imbalances between countries in the EU and in the Eurozone in particular (**Figure 4**). It should be noted, in particular, how the situation for peripheral countries has improved. Ireland has had a current account surplus since 2010; Spain has reduced its deficit by 7 percentage points from the peak of 2007 and is expected to reach equilibrium in 2013; and the situation in Portugal, Italy and Greece has also evolved positively. The figures for these countries contrast with the reduction in Germany's current account surplus since 2008, which is contributing to closing the gap within the Eurozone.



Source: Eurostat.

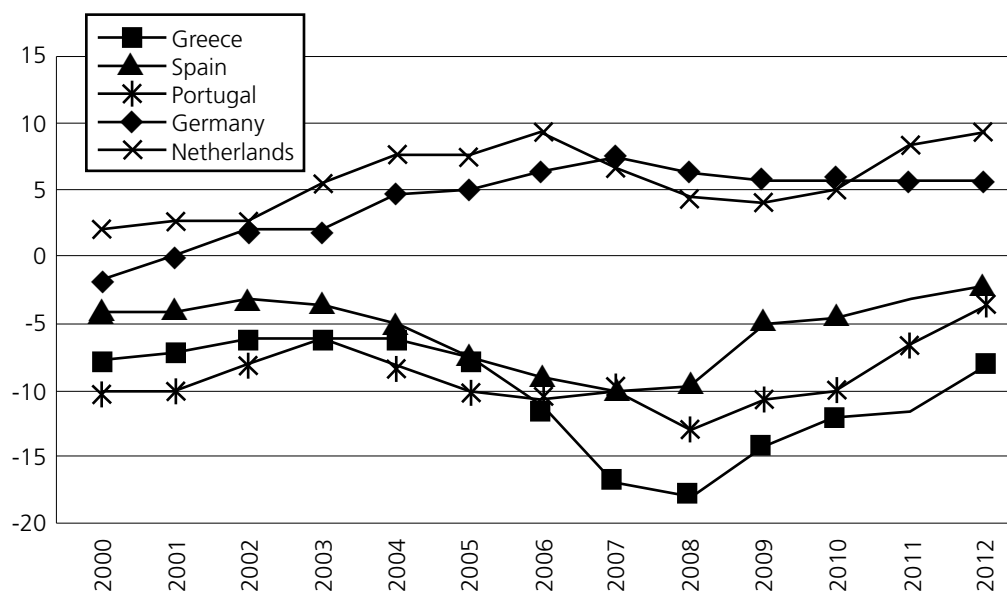
Figure 3. Outstanding public debt 2012 as a proportion of GDP

Although Greece is evolving positively, its current account deficit (−8.3 per cent of GDP) is unsustainable in the midst of a severe recession that has dragged on for more than four years, a reflection of the failure of the national economy to finance internal investment. The main problem facing Greece, however, is the fact that it needs to seek external financing but remains frozen out of the foreign debt markets; the funds can therefore come only from international organisations, whether the European Central Bank (ECB), the European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) or the International Monetary Fund (IMF).

The sustained reduction in foreign trade deficits for the peripheral Eurozone countries is

partly due to sluggish imports – given the weakness of domestic consumption – but especially to a significant rise in exports in response to improvements in relative competitiveness. However, the data indicate that greater price competitiveness is responding to deflationary processes, which, by undermining the real purchasing power of wages, is having a painful social impact (**Figure 5**). In fact, the four peripheral countries are effectively experiencing a fall in real exchange rates that is translating into a reduction in real unit labour costs.

The current situation reveals a significant deterioration in certain underlying economic indicators, concealed by the apparent normality of the period 1999 to 2007, when annual growth



Source: Comisión Europea.

Figure 4. Current account of the balance of payments as a proportion of GDP

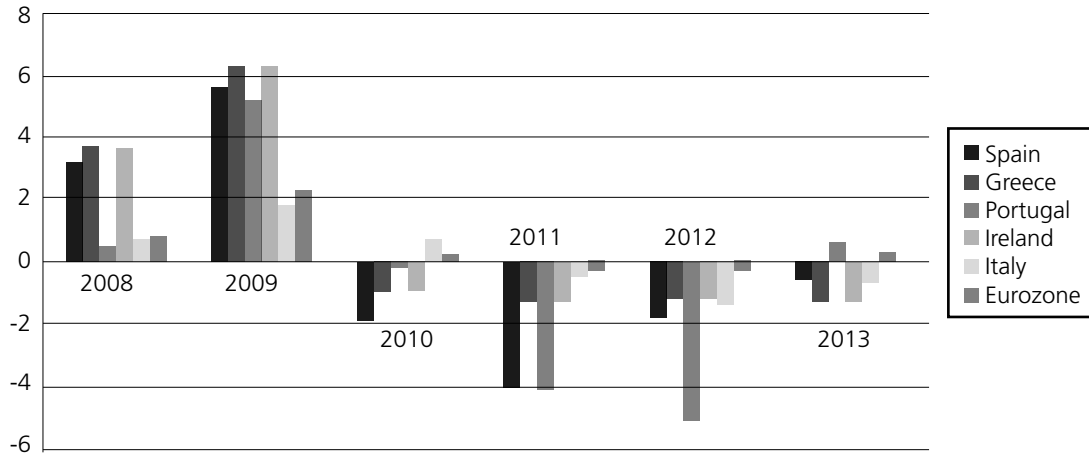
rates for the Eurozone overall were reasonably satisfactory. A number of countries recorded activity levels beyond the possibilities of their own production capacity, whether thanks to the generous availability of credit (for example, Spain) or to a highly expansionary and unbalanced fiscal policy (for example, Greece). The lop-sided growth in trade balances (surplus/deficit) was a result of differing levels of competitiveness for goods and services produced by the member states. Furthermore, those member states with positive balances found themselves with an excess of money that was offered to deficit countries, which then accumulated enormous private and public sector debt.

The ongoing mismatch between trade balances is an example of considerable differences in the competitiveness of Eurozone economies relative to each other and to the world at large. This imbalance in productive capacity generates ongoing problems in a single-currency area

lacking in common instruments for remedial action, clearly exemplified by differences in unemployment rates.

Economic Policy: Reinforced Austerity

Since late 2009, the absolute priority of EU economic policy has been to reduce the public deficit and debt levels that had risen sharply in the previous two years. The reforms widely referred to as the Six Pack, adopted in October 2011, strengthened the mechanisms of the Stability and Growth Pact (SGP). National budgets are now reviewed early on by EU authorities — in a policy coordination cycle known as the European Semester — to ensure that they are in line with the objective of reducing deficits to below 3 per cent by 2013. Countries whose sovereign debt is over 60 per cent of GDP are obliged to reach this limit within a maximum of 20 years (at an



Source: Eurostat.

Figure 5. Real unit labour costs (% change over the previous year)

annual reduction rate of at least one-twentieth). Procedures for non-compliant countries have also been reinforced and the European Commission can propose the imposition of sanctions that may be reversed only by a qualified majority vote. Also approved was the Euro Plus Pact, a political agreement between Eurozone governments that complements previous measures and moves towards economic policy commitments aimed at improving the competitiveness and also the complementarity of the economies.

The tightening of SGP rules has led to greater fiscal discipline in most Eurozone countries; however, the deficit objectives are not realistic and in all likelihood will not be met by several countries in recession. The new rules focus all national efforts on reducing the public deficit, overlooking other equally important long-term goals, such as those established in the Europe 2020 strategy. Moreover, the use of reverse qualified majority voting does not solve the problem of how to impose fiscal rules on larger member states.

The Treaty on Stability, Coordination and Governance

In December 2011, the Treaty on Stability, Coordination and Governance (TSCG) was approved by all 27 EU countries excepting the Czech Republic and the United Kingdom. This treaty was another step towards EU and – particularly – Eurozone consolidation of the objective of fiscal balancing as the dominant paradigm in member states' economic policies.

The conditions of budgetary stability included in the Maastricht Treaty were toughened. Participating states would have to ensure that their budgets were balanced or in surplus, with the public deficit limit now set at 0.5 per cent of GDP² (as opposed to the 3 per cent contemplated in the SGP). The new rule referred to the

² States with a public deficit »significantly« below 60 per cent of GDP would be allowed a structural public deficit equivalent to 1 per cent.

structural public deficit; that is, it excluded deficits caused by the business cycle.³ Moreover, as already mentioned, a new quantitative rule was established, whereby public debt exceeding 60 per cent of GDP had to be reduced at the rate of one-twentieth a year, irrespective of the business cycle stage.

The impulse behind the TSCG came from Germany, which convinced the other EU member states to establish internal EU rules that would restrict discretionary public spending – preferably rules of a constitutional nature and of general application and, once again, rules that would apply irrespective of the business cycle stage. This meant the juridification of a very specific economic policy option aimed at imposing legal limits on the use of budgets as counter-cyclical economic instruments. That is, an economy's growth rate could fall from 3 per cent to 1 per cent in inter-annual terms, but, since it would not technically be in recession (normally understood to be negative growth in two consecutive quarters), it would have to respect the upper limit on total public deficit.

Finally, it is important to note that the TSCG is an international, inter-governmental treaty and, although it operates alongside and is closely linked to the European integration process, it is not included in the Community framework. Since this situation renders European economic governance more complex and inefficient, a medium-term review of EU treaties aimed at fully integrating such agreements into the EU structure is necessary.

³ For example, an increase arising from budgetary provision for unemployment benefit. In any case, there is some controversy regarding how this is calculated.

The Compact for Growth and Jobs

Nicolas Sarkozy's departure in May 2012, after losing the French presidential elections, led to a rupture of the French–German partnership that had been preeminent in Europe from the beginning of the crisis. It was hoped that the arrival of François Hollande would re-route European economic policy by relaxing deficit-reduction targets somewhat and placing more importance on economic recovery and job creation.

The new direction taken by the French government was eventually translated, in Brussels, into the Compact for Growth and Jobs (CGJ), approved by the European Council on 29 June 2012. The CGJ led, via various instruments for growth and employment, to the unlocking of around 120 billion euros of European funds. The CGJ consisted essentially of the following:

- A 10 billion euro increase in paid-in capital for the European Investment Bank (EIB) that expanded its lending capacity by 60 billion euros and unlocked additional investments of up to 180 billion euros.
- Acceleration and reorientation of EU structural funds amounting to 55 billion euros for growth-enhancing and job-creation programmes.
- Launch of a project bond pilot phase worth 4.5 billion euros to be invested in key transport, energy and broadband infrastructure projects.

Even in a best-case scenario, the impact of this plan — equivalent to 1 per cent of the EU's GDP — will be modest and only felt in the medium term. Nevertheless, four months later, a positive initial assessment of progress in implementing the CGJ was made at a European Council meeting of 18–19 October. Reporting to the Council, however, the European Commission recognised the difficulty of rapidly unlocking

55 billion euros from the structural funds for injection into countries, since disbursement depends largely on member states' willingness to make additional contributions to the EU budget.

This situation serves to highlight the paradoxical problem with the EU budget. European funds successfully disbursed and redirected to dynamic projects have the potential to generate economic activity and growth. However, the obligation to comply with deficit targets imposed by the same EU authorities forces member states to make drastic spending cuts. Hence, they have to make additional cutbacks in order to be able to make the CGJ disbursements. The net impact on growth of the two contradictory mechanisms could be positive, even if limited, if the funds were channelled to countries in recession and into projects that would have a knock-on effect. The battle for the distribution of European funds has intensified enormously, however, in a recessionary context of a severely depleted public purse, as was made patently clear in the tremendously difficult negotiations regarding the European budget for the period 2013–2017.

Problems Accessing Money Markets and the ECB's Response

In the past two years, the difficulty of accessing external money markets has revealed how the exchange stability inherent in a single-currency area does not necessarily imply limitless access to funding. Furthermore, monetary union is no guarantee of a single interest rate for all member states, despite the existence of a monetary policy with a single intervention rate fixed by the ECB. The rise of the dreaded risk premium to the dizzy heights experienced in several countries confirms this statement (see the

Fundación Alternativas Report on the State of the EU 2011). Problems in financing sovereign debt were, in fact, the trigger for the Eurozone crisis.

The ECB's monetary response in the past year has been somewhat expansionary, both qualitatively — via a low interest rate of 0.75 per cent, even if still higher than in the United States, the United Kingdom and Japan — and quantitatively — via an injection of liquidity in two tranches of 500 billion euros at 1 per cent for three years, flexible access to credit for financial institutions and penalties applied to the deposit facility.

A comprehensive assessment of the ECB's policies and performance is beyond the scope of this chapter; however, monetary policy has had minimal impact on a far from expansionary aggregate money supply. It seems evident that success in reactivating the credit lines so vital for economic recovery has been limited. In all likelihood, this is due to a continuing lack of trust between institutions and to financial institutions' continuing failure to absorb impaired or illiquid assets, irrespective of whether these assets are their own (real-estate loans) or imported from the United States. Credit is not filtering through to the real economy because, as a precautionary measure (and even forgoing nominal remuneration), banks are using the acquired liquidity to top up their accounts at the ECB or to buy public debt; receiving higher rates than those paid to the ECB, they are, in a way, acting as »intermediaries« to channel ECB funds.

In September 2012, faced with continuing tension in the bond markets, the ECB announced a new outright monetary transaction (OMT) programme for three-year bonds as a means of support for countries paying high risk premiums. The condition imposed by the ECB was for the country in question to request a

bailout from the EFSF/ESM and to comply with strict macroeconomic criteria. The fact that purchase would be unlimited draws the ECB closer to playing the role of lender of last resort. The mere announcement of the OMT programme immediately calmed the markets, resulting in a significant fall and stabilisation of the risk premium. However, by the end of 2012, the risk premium for Italy and Spain (at around 270 and 350 basis points, respectively) remained excessively high because of the tremendous burden of financing the public debts.

The Austerity–Growth Debate

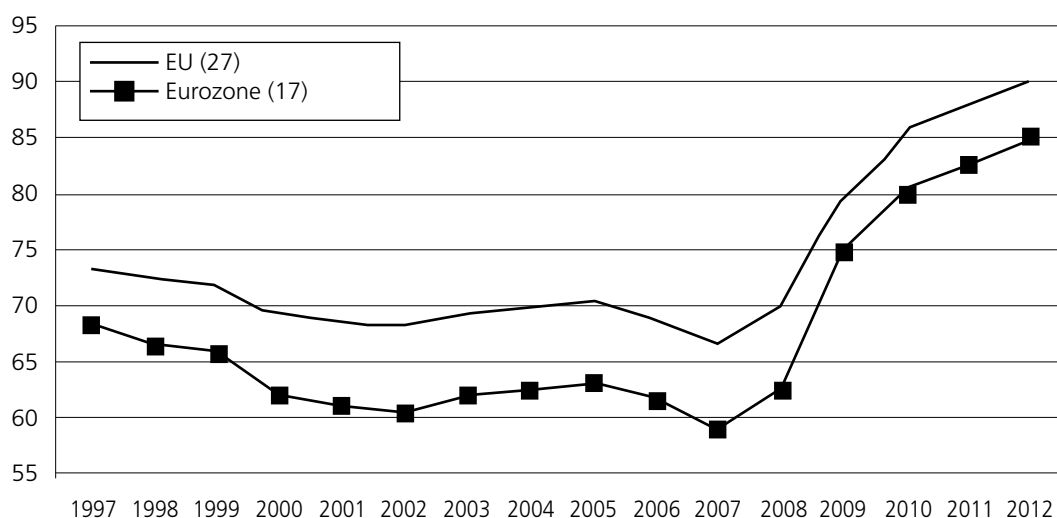
Public debt expansion in the EU economies and particularly in the Eurozone over the past few years has been spectacular (**Figure 6**). For the Eurozone overall (coinciding with the beginning of the financial crisis), public debt has soared to 90 per cent of GDP since 2007. Although the problem is more one of private rather than sovereign debt in several countries (Spain among them), the rapid growth in public borrowing is clearly worrying. Recent research⁴ based on solid empirical evidence indicates that there is little correlation between growth and public debt if debt is kept below 90 per cent of GDP. However, debt above this figure is associated with an economic downturn of up to 1 per cent of GDP on average per year.

⁴ Particularly noteworthy, apart from the IMF report titled *World Economic Outlook: Coping with High Debt and Sluggish Growth* (October 2012), are studies by Kenneth Rogoff and Carmen Reinhart, including: *This Time is Different, Eight Centuries of Financial Folly* (2011), Princeton University Press; Growth in a time of debt (2010), in: *American Economic Review: Papers and Proceedings*, Vol. 100, No. 2, p. 573–78; and *The Liquidation of Government Debt* (2011), NBER Working Paper No. 16893, Cambridge MA: National Bureau of Economic Research.

In the case of the EU, the rapid growth in sovereign debt leaves little doubt about the need for a solution. Two other factors also point to the need for a reduction in public debt. First, an ageing European population will mean higher public spending on pensions and health in the coming years; and second, there has been a sea change in how risk is assessed by financial markets so that, nowadays, similar debt and growth levels demand higher interest rates.

In view of the situation outlined above, the stabilisation and steady reduction of sovereign debt emerges as an important medium-term objective for the Eurozone overall, but as a far more urgent goal for some countries — to prevent debt reaching unsustainable proportions but also to reduce the negative impact on private saving and investment rates in the medium term and so positively impact on growth.

However, while there is no questioning of the need to implement fiscal consolidation processes aimed at stabilising debt levels, what is widely debated is the pace and scope of such processes in the current scenario. The debate has intensified as a result of new evidence about the size of the fiscal multiplier that has had a significant impact on public perceptions of the efficacy of the adjustment policies pursued in the EU to date (see *IMF World Economic Outlook: Coping with High Debt and Sluggish Growth*, October 2012). In this IMF report, empirical evidence is provided for the impact of fiscal multipliers being much greater than was formerly believed. Previously it was thought that a fiscal cut of around 1 per cent of GDP had a negative impact on economic activity of around 0.5 per cent of GDP. However, it now appears that the effect of fiscal multipliers is two or three times greater, with a fiscal cut of 1 per cent causing an economic contraction of between 0.9 per cent and 1.7 per cent of GDP. So,



Source: Eurostat.

Figure 6. Public debt in the EU and the Eurozone as a proportion of GDP

for a medium-sized European country, a fiscal adjustment of 1 per cent applied in mid-recession and fundamentally consisting of spending cuts could lead to a reduction in economic activity of around 1.5 per cent — and, in practice, would simply add to the country's deficit. Furthermore, the impact of a fiscal cut on the economies of peripheral countries with high debt and deficit levels is amplified in at least three ways:

- Deleveraging processes by private agents and by financial institutions further shrinking domestic demand and reduce credit, respectively.
- Low inflation rates magnifying the effect on nominal values for all variables, with the result that restrictive fiscal policies have a greater negative impact on GDP which, in turn, hits employment and indebtedness as a proportion of GDP.
- The absence of a more expansionary monetary policy temporarily compensating for fiscal contraction. With a Eurozone reference

interest rate already close to zero and with an ECB mandate to contain inflation, use of other mechanisms — like quantitative easing as used by the US Federal Reserve and the Bank of England — is considerably restricted.

In short, implementation of a rigid fiscal consolidation process has narrowed the balance of payments gap but has incurred a very high cost in terms of depressing economic activity, raising unemployment and aggravating public debt growth. In the peripheral countries hardest hit by recession, adjustments are clearly choking their economies and are hindering attempts to meet deficit-reduction targets — not to mention doing little to restore investor confidence (another prime objective).

Greece has been greatly weakened by four consecutive years of recession, with public debt still growing even after a partial write-off (forecast at 176 per cent of GDP by the European Commission and 180 per cent of GDP by the IMF), and with unemployment expected eventually to reach 23 per cent of the active popula-

tion. Portugal is in a marginally better economic situation, but two years of recession and steadily growing unemployment (15.5 per cent of the active population in 2012) make it incapable of reining in its outstanding public debt balance (119.1 per cent of GDP). Recession and sovereign debt patterns in Ireland are similar, although unemployment has been held in check by emigration of part of the active population. Spain and Italy — which have not yet been bailed out (at least formally) — are quite similar in terms of economic activity, outstanding debt and unemployment levels (**Tables 2 and 3**).

In this scenario, one of the solutions for recession would be higher exports spurred on by greater competitiveness. However, the existence of a monetary union and the resulting impossibility of becoming more competitive through nominal devaluation is leading many peripheral countries along the path to real devaluation. In other words, devaluation is occurring via internal deflation of prices and salaries — a much slower and much more economically and socially painful alternative.

The situation and economic policies being applied in Europe contrast sharply with those applied on the other side of the Atlantic, where Obama's government has opted to apply more expansionary monetary and fiscal policies. The US economy has not completely recovered, particularly as regards employment, but in 2010, 2011 and the first three quarters of 2012 it consistently grew more than the EU economy (**Figure 7**). There are, admittedly, many differences between the United States and the EU, but, to some extent, the United States has demonstrated that alternatives to the draconian austerity policies — as applied in the EU at present — can and do work. Such policies give precedence to growth and employment maintenance targets over deficit reduction goals.

Alternative Economic Growth Policies

The policies applied since 2010 to tackle the crisis have caused a breach of confidence between creditor and debtor countries within the Eurozone. Even acknowledging the need to reduce sovereign debt, it has to be recognised that simultaneous and accelerated adjustment policies are having negative repercussions on economic activity, with ensuing limitations on the generation of wealth and employment and, consequently, on the capacity to repay debt.

The continuing fiscal adjustment by troubled countries is simultaneously causing fatigue in the populations of peripheral countries and weakening public support in core countries. Leaving aside the arguments in favour of different options, the current scenario is engendering economic and social instability, which, in turn, is proving an impediment to overcoming the problem of sovereign debt. This problem is largely a crisis of confidence in the euro. Investor fears, if they reach panic levels, could result in interest rates that would push even more countries over the brink from illiquidity to insolvency, thus damaging their financial and fiscal systems to the point where surviving countries would simply not have enough critical mass even to justify the existence of a single currency. Simultaneously, the population may question the wisdom of continuing in a monetary union that generates too much uncertainty and that fails to meet their needs.

A detailed analysis points to common interests that, if well managed, could override private (political and economic) interests. On this basis, we can outline a tactical position and a strategic position. In the short term, it is crucial for Eurozone countries to shoulder and to share the cost of a monetary union that, first,

Table 2. Public and private debt in peripheral EU countries as a proportion of GDP

		2007	2008	2009	2010	2011	2012 ^f	2013 ^f	2014 ^f
Deficit	Spain	1.9	-4.5	-11.2	-9.7	-9.4	-8.0	6.0	-6.4
	Greece	-6.5	-9.8	-15.6	-10.7	-9.4	-6.8	-5.5	-4.6
	Ireland	0.1	-7.4	-13.9	-30.9	-13.4	-8.4	-7.5	-5.0
	Portugal	-3.1	-3.6	-10.2	-9.8	-4.4	-3.1	-2.5	-0.9
	Italy	-1.6	-2.7	-5.4	-4.5	-3.9	-2.9	-2.1	-2.1
Sovereign debt	Spain	36.3	40.2	53.9	61.5	69.3	86.1	92.7	97.1
	Greece	107.4	112.9	129.7	148.3	170.6	176.7	188.4	188.9
	Ireland	24.8	44.5	64.9	92.2	106.4	117.6	122.5	119.2
	Portugal	68.4	71.7	83.2	93.5	108.1	119.1	123.5	123.5
	Italy	103.3	106.1	116.4	119.2	120.7	126.5	127.6	126.5
	Zona euro	66.4	70.2	80	85.6	88.1	92.9	94.5	94.3

Source: Eurostat.

^f Forecast.

was poorly designed, and second, was the object of abuse or non-compliance with the principle of prudence by creditor and debtor countries. Ultimately, there was a failure to control the quantity of money in circulation and the quality of loans granted by financial institutions. Attempts should therefore be made to find ways to fairly share the burden of these problems. Our recommendations are as follows:

- Postpone the calendar for cleaning up public accounts so that adjustment does not exceed 1 GDP percentage point per year. This

would reconcile medium-term budgetary stability with short-term economic recovery.

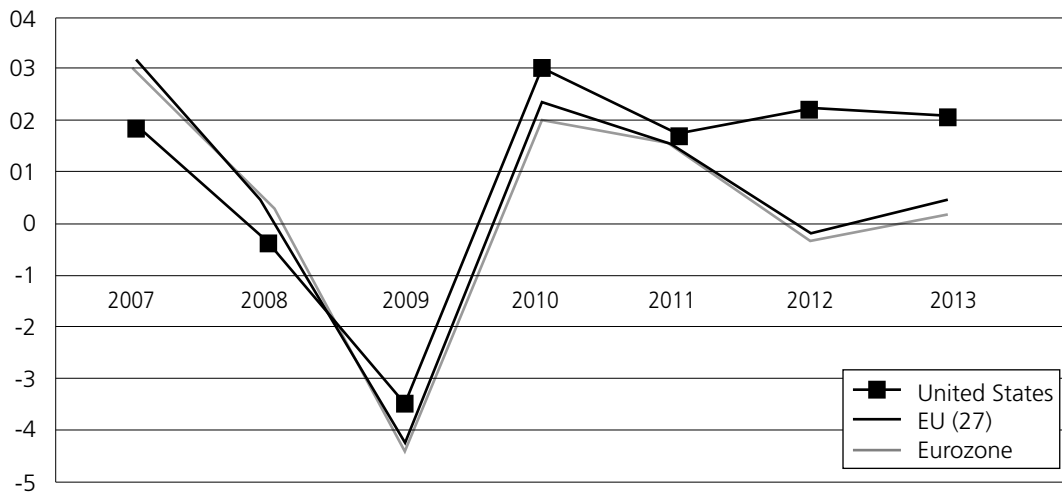
- Differentiate between structural and cyclical deficits so that built-in stabilisers can be brought to bear on fiscal consolidation processes.
- Guarantee access to funding at a reasonable rate through common instruments (ECB or ESM, granted a banking licence to bypass their restricted powers for action, currently amounting to 500 billion euros to stabilise a debt market worth 2.8 trillion euros in Italy

Table 3. Real growth rates in peripheral EU countries

Countries	2008	2009	2010	2011	2012 ^f	2013 ^f	2014 ^f
EU (27)	0.3	-4.3	2.1	1.5	-0.3	0.4	1.6
Eurozone (17)	0.4	-4.4	2	1.4	-0.4	0.1	1.4
Ireland	-2.1	-5.5	-0.8	1.4	0.4	1.1	2.2
Greece	-0.2	-3.1	-4.9	-7.1	-6	-4.2	0.6
Spain	0.9	-3.7	-0.3	0.4	-1.4	-4.1	0.8
Italy	-1.2	-5.5	1.8	0.4	-2.3	-0.5	0.8
Portugal	0	-2.9	1.4	-1.7	-3	-1	0.8

Source: Eurostat.

^f Forecast.



Source: International Monetary Fund.

Figure 7. US and EU growth rates (as a percentage of GDP)

and Spain alone).⁵ This process should also allow for temporary debt restructuring (minimum 10 years) to prevent collapses triggered by maturing short-term debt. This partial debt mutualisation option would improve possibilities of debt recovery, even though there would be costs resulting from a possible rise in the interest rate applicable to the outstanding debt.

- Put in place an expansionary, or at least neutral, economic policy in aggregate terms, expressed as the sum of contributions of countries with trade and fiscal surpluses and the competitive devaluations of countries with trade and fiscal deficits. Competitiveness gains in deficit countries would be more likely if countries with margins (for example, Germany) boosted domestic demand with pay rises and were willing to tolerate a slight increase in inflation. The entire adjustment

process would be easier, in fact, if the ECB temporarily allowed a slightly higher average inflation rate for the Eurozone.

- Bolster common monetary policy as exercised by the ECB via a banking union and a single bank supervisor.⁶ This would prevent, at the national level, slack conduct and mistaken or self-interested interpretation of objectives that could have a negative impact on partner countries. Controls directed at ensuring a healthier financial system could be strengthened so as to prioritize actions in favour of productive activities in detriment of an excessive financialization of the economy.
- Reform the financial system so as to immediately restore lines of credit, at the lowest possible cost to taxpayers (that is, applying penalties to bank owners and managers).

⁵ In this regard there is an urgent need for ESM capital to be increased to 1 trillion euros.

⁶ Contrary to what is being planned, banking supervision should not be restricted to the Eurozone, since – apart from being an internal market issue – the European banking crisis does not distinguish between institutions domiciled inside and outside the monetary union.

- Advance firmly towards a common fiscal policy, enforced and supervised by EU-wide institutions, with the goal of ensuring long-term sustainability and stability throughout all business cycle stages. In particular, new quantitative rules should be included in the TSCG referring to the growth rate that would expressly admit public deficit financing as an economic stimulus mechanism in times of low growth or recession. The exclusion of public investment from the calculation of structural deficit could also be considered.
- Allow for a lender last resort so that the euro can deal with specific problems related to the sustainability of public finances. The ECB would seem to be the logical choice, but the ESM could also carry out this function if it were granted a banking licence.
- Allow for a more powerful EU budget that would enable internal transfers of financial resources that would promote real Eurozone convergence. It would be necessary to accelerate and reinforce the Compact for Growth and Jobs, whose funds are not linked to national contributions.
- Develop a strategy of structural reforms to run alongside short-term policies in order to tackle, wherever possible, deficiencies generated by current imbalances. This strategy should include policies aimed at improving the competitiveness of Eurozone goods and services so as to achieve sustainable growth that is compatible with a social market model in which citizens assume the obligations and enjoy the advantages of being part of the EU project. This social perspective involves overhauling a welfare system in which the public sector plays a verifiable role in enhancing equity and efficiency in economic relations.
- Further develop the European internal market and, specifically, put measures in place that facilitate and encourage worker mobility within the EU (recognition of academic qualifications, pension rights, unemployment benefits and so on).

The European Central Bank in 2012

Domènec Ruiz Devesa¹

Introduction

The year 2012 marked a watershed in the history of the European Central Bank (ECB). In the face of opposition from the German Bundesbank – in itself an important precedent – the ECB has taken a different direction with a new leader² at the helm, the Italian Mario Draghi, whose mandate began in November 2011.

The ECB has reduced the interest rate – the price of money – to 0.75 per cent, has provided long-term liquidity to banks and has launched a new programme to purchase, with no limits on volume or term, government bonds for countries with balance of payments problems (Spain) or public debt sustainability issues (Italy).

These steps, as well as converting the ECB into the “crisis buster” *par excellence* for the European Union (EU), have significantly reduced financial instability in the monetary union. They are not sufficient, however: accommodative monetary policy alone will not resolve the serious unemployment resulting from the aggre-

gate demand crisis in the world economy, but especially on both sides of the North Atlantic. But they are very significant steps, as they have not only banished the spectre of a breakup through the implosion of the Eurozone’s weakest members, but have also underpinned the irreversibility of monetary union. This, together with the establishment of the internal market and the free movement of persons within the Schengen Area, is undoubtedly one of the most tangible and symbolic achievements of European integration to date.

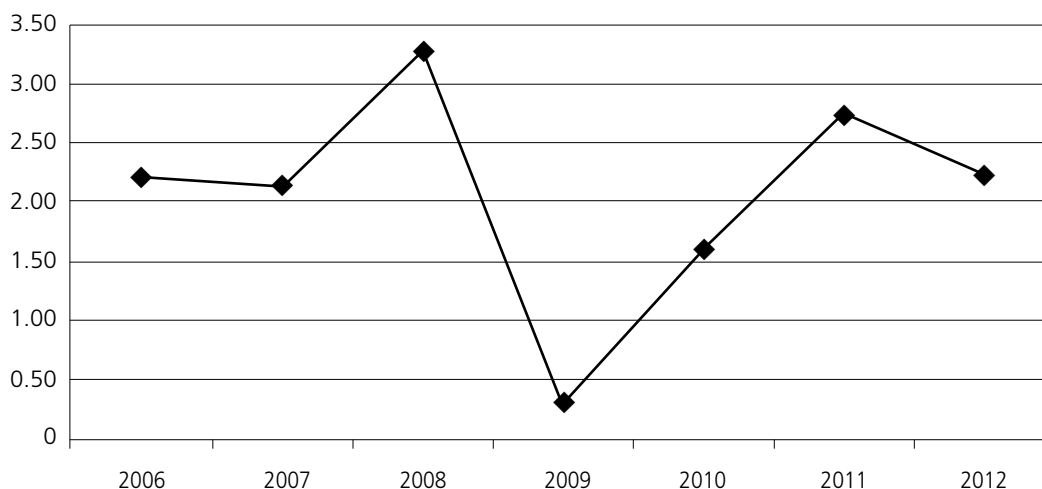
Five Years of Crisis

The ECB’s major about-turn of 2012 is no defence for the erratic, even erroneous path it pursued in the months and years following the onset of the financial crisis in the USA in the summer of 2007.

Looking at the evolution of the Harmonized Index of Consumer Prices for the Eurozone (**Figure 1**), with the exception of 2008 (when the financial crisis reached its zenith), inflation in annual terms has remained at the informal ECB target rate of around 2 per cent.

¹ The author is grateful to Manuel de la Rocha Vázquez for his contributions to the conclusions section of this article.

² He began his term on November 1 2011.



Source: Eurostat.

Figure 1. Harmonized Index of Consumer Prices (Eurozone)

Inflation has not been a problem in the past five years. In any event, spikes have no impact when the slowdown in economic activity is as dramatic as that experienced from 2009. Moreover, the implicit 2 per cent rule is highly arbitrary; Nobel prizewinning economists such as Paul Krugman and Joseph Stiglitz do not consider inflation rates of even 4 per cent or 5 per cent to be worrisome, even in economic booms. Since the implementation of austerity policies from 2010, the falling inflation rate has acted as an indicator of a relapse into recession (as happened in many EU member states in the period 2011–2012). As for the interest rate, a rising trend continued throughout 2007 until November 2008, indicating that the ECB was still thinking more in terms of price stability than financial stability.

In July 2008, just two months before the collapse of the infamous US investment bank Lehman Brothers, the ECB decided to raise interest rates. This error was repeated two years later, at a time when the possibility of recovery was not only remote but also frankly jeopardised by the implementation of contractionary fiscal policies

from 2010. The interest rate was quite rightly held at 1 per cent during 2010. In April 2011 it was raised but then reduced in November, coinciding with the change in the presidency of the ECB and the holding of general elections in Spain. Moreover, at the behest of the ECB, the Spanish Constitution was hastily reformed to include a strict balanced-budget rule.

Broadly speaking, except for Jean-Claude Trichet's final waverings in 2011, ECB monetary policy has been expansionary or accommodative (**Figure 2**), with the base rate pitched at between 0 per cent and 1 per cent. This rate is appropriate in a context of economic depression such as the one being experienced in the Eurozone; nonetheless, it should also be accompanied by spending policies and public investment. The current rate of 0.75 per cent has been in force since July 2012. In real terms, in fact, this interest rate is negative and so should, in theory, encourage consumption and investment over savings.

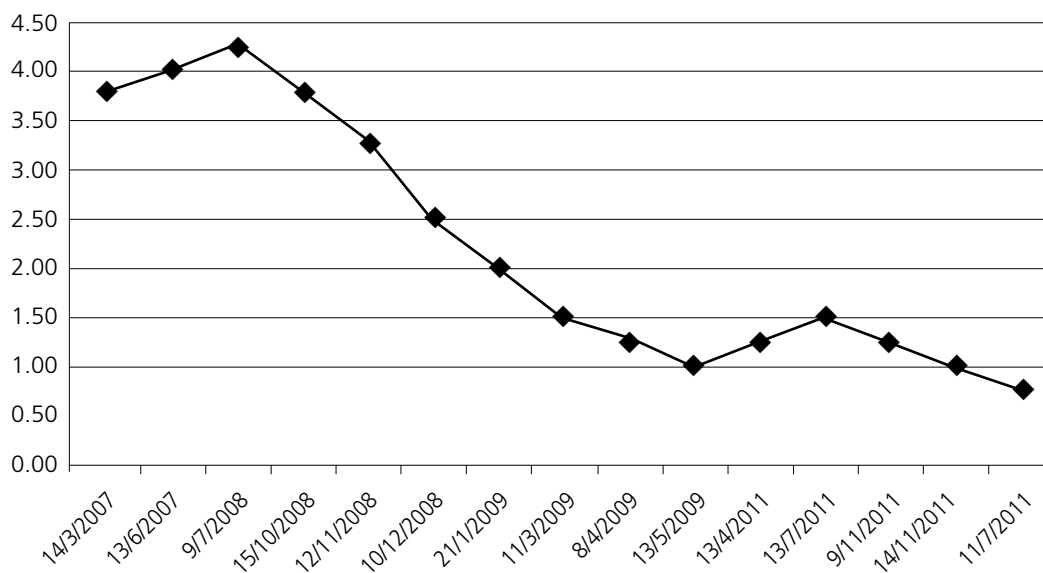
The ECB took another unorthodox and unprecedented step in 2012; it reduced the interest paid on money deposited with it by financial

institutions as a measure to encourage credit flows in the interbank market and towards the real economy. Since 14 December 2011, such deposits have earned a meagre 0.25 per cent.

It should be recalled that, to correct problems in the interbank market, the world's major central banks (the ECB among them) initially argued not for an immediate reduction in interest rates as for extraordinary liquidity auctions. This mechanism continues to be used, although, since March 2012, no quantitative limits or conditions have been imposed regarding the use of funds available at 1 per cent for a maturity period of three years. While this liquidity "open bar" will prevent bank failures in the short term, it does not ensure that credit is channelled to the productive economy; rather the incentives are strong for banks to buy government debt and so make an attractive profit.

The ECB can indeed be blamed for both its tardy announcement of the unlimited debt pur-

chase programme that ultimately stabilized the financial situation of the Eurozone and for other errors that aggravated the Eurozone's problems. The decision to suspend the first programme of government bond purchases from Spain, Italy and other peripheral countries in the spring of 2012 raised the spread with the German government bonds for these countries (the risk premium), making their funding more costly in the capital markets. This was the main factor that prodded Spain to request initial financial assistance from the European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) – limited, however, to stabilising its banking sector. The erroneous early cancellation of this programme of public debt acquisitions, worth 218 billion euros since its inception in 2010, in a way forced the ECB to announce an even more robust response to controlling financial market volatility. Thus, on 26 July 2012, the ECB President Mario Draghi, in London, firmly pledged



Source: European Central Bank.

Figure 2. European Central Bank base interest rate 2007–2012

that “the ECB is ready to do whatever it takes to preserve the euro”.

It is also clear that the ECB overreached itself in August 2011 in making support for Spanish and Italian public debt conditional on the adoption of a series of policies, including, in the case of Spain, a constitutional reform to cap the budget deficit at 0.5 per cent of GDP. Imposing conditions is not, in fact, admitted by the current statutes of the ECB, whose legitimacy in democratic terms is indirect. The ECB’s task is to intervene in bond markets to reduce short-term volatility, irrespective of any policies pursued by member states. The imposition of policy conditions is more a matter for the International Monetary Fund (IMF) and the EFSF/ESM in their multilateral lending roles.

The End of the Beginning

The ECB may have acted tardily, but it did act courageously from the summer of 2012. Although its actions have been entirely legal, it has become commonplace to claim that the ECB’s interventions in the public debt markets are diluting the distinction between fiscal policy and monetary policy. The ECB, moreover, is also viewed by many to be exceeding its mandate, which is, in theory, to ensure price stability.

Since the beginning of the crisis, internal strife and differences have marked the Executive Board of the ECB, eventually culminating in a clear victory for board members who prefer less orthodox policies. The result has been high-profile resignations, such as that of the ECB’s chief economist, the German Jürgen Stark, in September 2011, in total disagreement with the first bond purchase programme, and also of the President of the Bundesbank, Axel Weber. More recently, nonetheless, Mario Draghi could even

count on German Chancellor Angela Merkel’s support for an ambitious new programme aimed at underpinning the public debt of the peripheral countries, although alienating the German Bundesbank chief, Jens Weidmann, as the only dissenting voice in the Governing Council of the ECB.

A cursory reading of the ECB statutes in no case endorses the view of hawks such as Jürgen Stark, who also happens to oppose the establishment of a financial stability fund for the Eurozone. Although Mario Draghi may like to refer to a monetary policy transmission problem to justify recourse to buying government bonds, the key lies, in fact, in Article 127.5 of the Treaty on the Functioning of the European Union, which clearly states that the ECB is empowered to take measures that contribute to the maintenance of financial stability. While Article 123.1 prohibits direct purchases in government debt auctions, the ECB is allowed, through what are called open market operations (OMOs), to purchase bonds already issued and traded in the secondary markets – as is normal practice for any central bank in the world.

We should not lose sight of the fact that Mario Draghi seemed to make the debt purchase programme conditional on a request for assistance from the EFSF/ESM by countries in difficulty, Spain among them. Since Spain had already activated an EFSF/ESM credit line to clean up its financial sector, it was unclear whether it had already fulfilled the condition or whether it should request a macroeconomic aid programme for its economy overall. Be that as it may, the financial markets eventually stabilised in the last quarter of 2012 (**Figure 3**).

The summer of 2012 undoubtedly marked a watershed for the ECB, the Eurozone and the future of European integration, as this was when the base rate fell to its lowest level in the

history of the euro and when a pro-active policy was successfully inaugurated to support the public debt of the peripheral countries. In regard to the severe economic and social crisis – especially unemployment – that is assailing Europe, although we may not be witnessing the beginning of the end, to paraphrase Winston Churchill, we can certainly refer to the end of the beginning: for the first time since 2010 the EU is taking firm steps to ensure financial stability through its uninhibited and unorthodox use of its main weapon in this area, namely, the ECB.

The ECB and a New Oversight Era

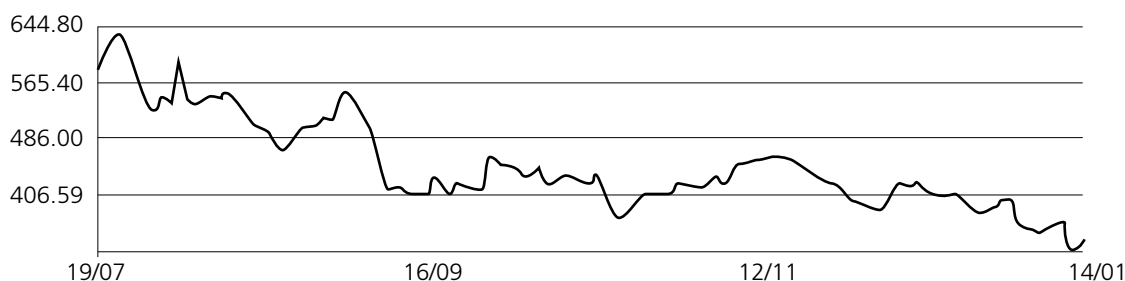
The other major issue that placed the ECB centre-stage in 2012 was its new banking oversight role. As a result of European Council agreements in June and December 2012, the ECB will become, from 2014, the only supervisor of the approximately 150 systemic banks in the Eurozone and potentially of any of 6,000 other banks that could find themselves in difficulty. This is what has been termed as a “banking union”, although it is limited to the countries of the Eurozone.

The establishment of a supervisor for the European financial sector is certainly justified by the major failures detected in the performance of national supervisors. However, the fact that the ECB will become the guardian of the main Eurozone banks is not necessarily an advance; this is because, if the EU is truly a single market, then not only regulation but also supervision should be the same for everyone.

Furthermore, the distinction between European-wide regulation and other supervision levels is artificial, as supervisors create rules through their decisions, instructions, circulars and so on. This would lead, in the medium term at least, to multiple regulations governing the EU financial sector, which the European Banking Authority (EBA) would be required to harmonise.

There is also the risk of financial contagion; this is not specific, moreover, to countries that use the euro, firstly, because the euro is unable to distinguish between entities domiciled inside or outside the Eurozone, and second – and more importantly – because the EU’s (and the world’s) main financial centre, the City of London, lies outside the Eurozone.

Finally, the European Council agreement of June 2012 did not point to the ECB itself as the



Source: *El Economista*.

Figure 3. Spread between Spanish and German 10-year bonds July 2012 to January 2013

supervisory body; rather, it merely indicated that the ECB should participate in the supervisory body. It would be preferable to strengthen the EBA as a body, as this would extend supervision from the Eurozone to all the EU member states, in perfect symmetry with unified EU legislation.

Conclusions: Achievements and Reforms to Come

The replacement in November 2011 of Jean-Claude Trichet by Mario Draghi as President marked a point of no return in the history of the ECB and – leaving aside the incomprehensible suspension of the first government bond purchase programme in the spring of 2012 – had a positive impact on Eurozone financial stability.

In this new phase, the ECB has generally adopted a much more pro-active, ambitious and, in our view, effective policy, resulting in three major decisions taken during 2012:

- Reversion of inexplicable base rate increases implemented during the Trichet mandate to bring the repo rate below 1 per cent.
- Extension of uncapped long-term (three-year) credit lines to ensure bank access to financing.
- Launch of a second, more ambitious purchase programme for government bonds of peripheral countries in September 2011.

The combined impact of these three measures has been to significantly lessen tensions in the government bond markets and make credit less costly (a precondition for economic recovery). It is crucial to maintain this focus throughout 2013 and for as long as is necessary, that is, for at least until banking systems have readjusted, economic recovery is under way and employment is growing.

Mario Draghi's ECB has remained faithful to orthodoxy in many aspects. For example, in its management of the Greek financial crisis it remained adamantly opposed to compulsory writedowns by private investors. It also imposes no conditions on how the liquidity it provides is used by financial institutions, so it requires no guarantee that investments are being made in the productive economy. Finally, the ECB has remained committed to fiscal tightening policies to reduce deficits and public debt and to enhance growth – despite the empirical evidence available on both sides of the North Atlantic. Leaving aside the successful policy changes implemented to date, nonetheless, the effectiveness of the ECB would be increased were its statutes to be reformed in the next review of treaties (ideally within the framework of a new constituent assembly).

When the ECB was created, its mandate and functioning were strongly influenced by the Bundesbank, as reflected in its statutes. Thus, its stated primary objective is to maintain price stability; all other goals, although not specified other than in general terms of supporting the EU's economic priorities, are subordinate. In the end, Germany agreed to forgo its *deutschmark* in exchange for a governance structure for the new monetary union that would comply with orthodoxy and with the discretionality rules contained in the treaties.

The ECB, in particular, is expressly forbidden to finance the deficits of any member state or even of the EU itself or its agencies: this is the “no bail-out clause” contained in the aforementioned Article 123.1. This mandate contrasts with the priorities and objectives of other central banks, such as the US Federal Reserve or the Bank of England. The ECB's inflationary corset has proved problematic; it is limiting its ability to intervene to protect the euro, since, outside of

OMOs, it is unable to act as lender of last resort. In practice, in the face of an erroneous perception that it was juggling with the limits of its mandate, the ECB has intervened in the secondary markets (initially with great timidity), buying up government debt to ensure euro stability against speculation.

The ECB's decision to admit the possibility of unlimited interventions in secondary markets aimed at stabilising public debt markets, albeit under strict conditions and monitored by the EFSF/ESM, is most certainly a step in the right direction. Nonetheless, it does not go far enough. We make the following recommendations:

- The ECB statutes need to be reformed so that, as well as its price stability function, it is given an explicit and equally important

twofold mandate to (1) ensure financial stability and prevent asset inflation in the Eurozone and (2) promote growth economic and employment. The inflation target should also be raised over 2 per cent, even though this rule (precisely because it is informal) is not actually reflected in the Treaty on the Functioning of the European Union.

- The European Parliament should formally ratify the appointment of the ECB President and of the members of the Executive Board. In the current EU Treaty the European Parliament only has to be consulted about these appointments.
- The ECB Governing Council should, like the US Federal Reserve, be obliged to publish the full, transcribed proceedings of all its meetings.

The Financial System: Crisis and Reform

Ángel Bergés, Emilio Ontiveros

Background: Financial Fragmentation in the Eurozone

The European financial system has never been so close to implosion as in 2012. At the epicentre this time was Spain (like Greece, Portugal and Ireland in 2010 and 2011), experiencing an adverse feedback loop between an economy in severe recession, fiscal adjustment that further deepened the crisis and a crippled banking system incapable of fulfilling its core mission of furnishing credit.

Against this background, we discuss the most important milestones in the evolution of the financial system in Spain and Europe in 2012. Abundant on both sides of the Pyrenees were policy decisions and actions with regard to the Spanish banking system, which has emerged as the main focus of concern regarding the European financial system.

Although the purpose of the chapter is to review 2012, to understand the full implications of what happened in that year we need to go back to the summer of 2011, when the events that triggered a major financial crisis in the Eurozone began to unfold. The Eurozone was already experiencing serious credibility problems

due to its handling of the successive crises that unfolded in the three small economies that were eventually bailed out, one of them (Greece), twice.

The lack of credibility in managing the crises in these smaller countries had a knock-on effect on the Spanish and Italian economies, leading to major vendor tensions in their government bond markets in the early summer of 2011. Nonetheless, the key escalating element in the Eurozone financial crisis was the freezing of the wholesale funding markets for almost all of Europe's banks in the summer of 2011. The major French banks were especially affected by this situation, as they were excessively reliant on short-term securities in both the euro and dollar markets and so were especially vulnerable to any system-wide freeze. According to International Monetary Fund (IMF) estimates, the large French banks saw their dollar funding lines from US money markets cut by almost 100 billion euros.

LTROs: Curing One Ill with Another

Central banks responded to the collapse in wholesale funding for European banks in two

ways. The first, aimed at repairing the extraordinary liquidity risk to which the European banking sector was exposed, was for the US Federal Reserve, in coordination with the European Central Bank (ECB), to grant funding through swap lines to European banks dependent on dollar funding. The second, more decisive measure was the ECB's announcement of two long-term (three-year) refinancing operations (LTROs) in two tranches to be allotted in December 2011 and in February 2012.

Compared with the ECB's previous policy of liquidity injections, the LTROs represented an extraordinary step forward in three ways:

- They involved funding granted for a term (three years) never before contemplated by the ECB (the maximum had been one year, for special financing operations in 2009).
- No quantitative ceiling applied, provided the financial institutions had sufficient collateral (primarily, but not exclusively, public debt).
- A hugely reduced interest rate was offered, set initially at 1 per cent, that would be reduced in line with the ECB intervention rate (as happened, in fact, in July 2012 and which may well happen again in the coming months).

The LTROs were welcomed by the European banking system and led to two allotments of around 500 billion euros each, offered in late 2011 and early 2012.

An injection of funding on this scale by the ECB had an extraordinarily favourable impact on the European banking system, not only in terms of ensuring liquidity for a period long enough to allow wholesale markets to revert to normal, but also in terms of the generation of a financial spread, given that the funds provided by the LTROs would be invested in assets that would generate returns substantially higher than the cost of the funds. This was especially

the case for the peripheral countries (where public debt was more profitable), as their banks would be able to benefit from a significant spread through carry trading, whereby money obtained from the ECB at 1 per cent (and falling) would be invested in government bonds with much higher yields.

The opportunity could not be missed: Spanish banks flocked to the two auctions and were allotted some 200 billion euros. As a result, the aggregate borrowing position of the Spanish banking system was 400 billion euros in the spring of 2012 – representing 33 per cent of the total loan granted by the Eurosystem and almost three times the key capital share (11 per cent) corresponding to Spain. In fact, as can be seen in **Figure 1**, the Spanish banking system became by far the largest borrower of Eurosystem funds, significantly exceeding Italy and France, which, a few months previously, had been the main users of ECB funds.

The Adverse Feedback Loop between Banks and States

Heavy Spanish borrowing from the Eurosystem was to have very perverse effects, as the link between banking risk and sovereign risk became hugely amplified. This was because, as a way to monetise the funds made available by the ECB, Spanish banks purchased Spanish public debt on a massive scale in carry-trading operations, with the banks obtaining a higher interest rate on the public debt than they paid to the ECB.

As can be seen in **Figure 2**, Spanish banks dramatically increased their Spanish public debt holdings (by more than 60 billion euros) as a consequence of the two LTRO auctions. This increase coincided with a drop of almost the same

magnitude in Spanish public debt holdings by foreign investors. Thus, thanks to the support provided by the ECB, flows moved in a single direction: as foreign investors reversed their positions in Spanish public debt, Spanish banks took up the slack using ECB funds provided through LTRO auctions.

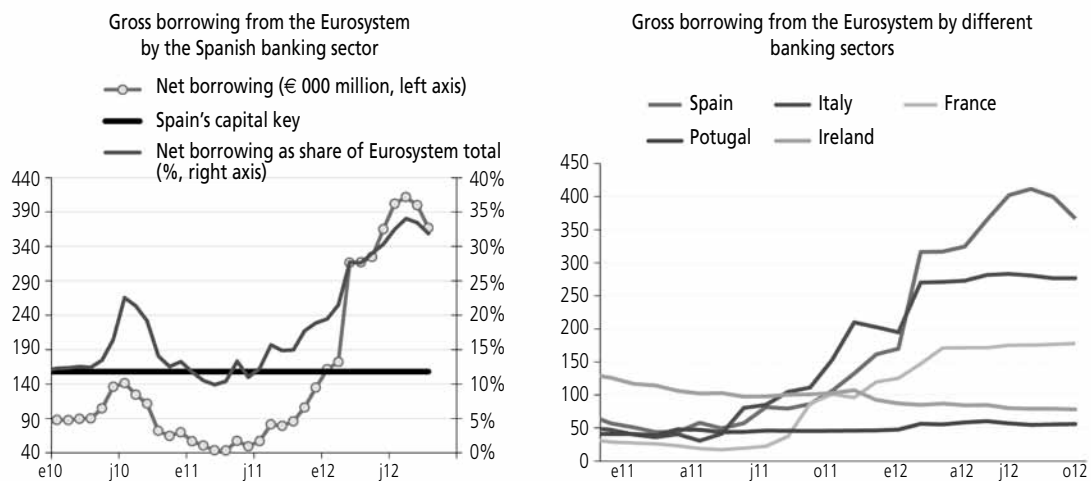
In fact, as shown in **Figure 3**, an ECB measure aimed at injecting liquidity into the banking system, at a time when wholesale financing was proving impossible, produced an extraordinarily perverse result that segmented bank dependence on the ECB in an unprecedented way. The banks of the peripheral countries – Spain, Italy and Greece, Ireland and Portugal (GIP) – became major ECB debtors and indirectly the main financiers of their respective treasuries; meanwhile, the public debt risk remained with the banking system of each country. In contrast, banks from financially the healthiest countries (Germany, the Netherlands and Finland) have accumulated large net claims on the Eurosystem.

A Crisis of Confidence in Spanish Banks

This extraordinary asymmetry in the position of banking systems in the Eurosystem was only the first sign that European financial integration was under threat. The most worrying manifestation became evident as early as the second quarter of 2012, when the perception of financial fragmentation reached deep into the heart of the finance system: high-street banking.

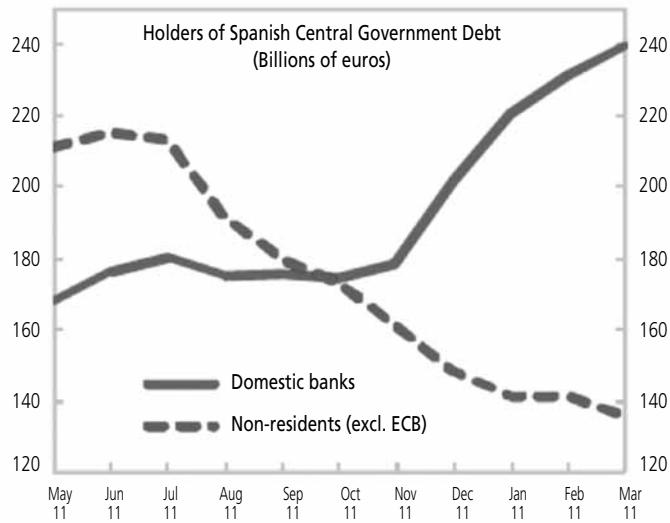
Figure 4 shows the evolution of deposits in banking systems in three broad behavioural categories. French and German banking systems experienced systematic growth in deposits; Greece, Ireland and Portugal continued to see a downward trend in 2012, following a trend established in late 2009; and a change in trend occurred in Italy and Spain at the turn of 2012, with a significant decline in deposits as compared to the stability, or even moderate increase, recorded in the previous year.

This asymmetric behaviour of bank deposits in different Eurozone blocks points to a



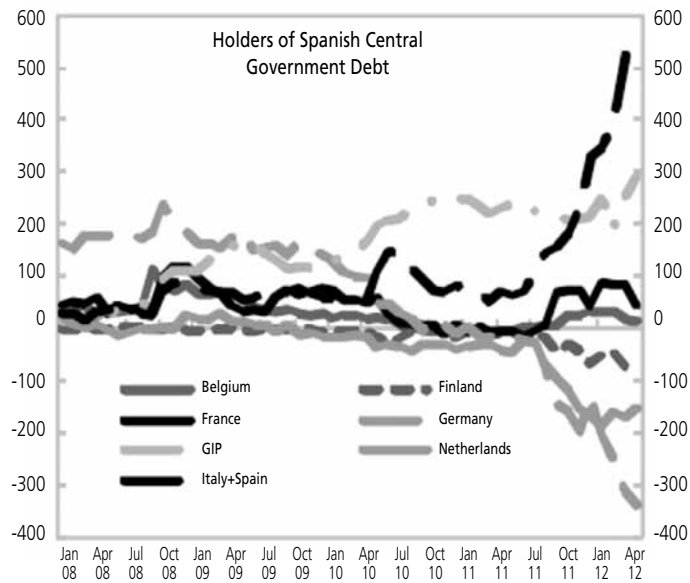
Source: Afi, ECB, Banco de España.

Figure 1



Source: Banco de España, IMF Country Report No. 12/182 (July 2012).

Figure 2



Source: IMF, International Financial Statistics database.

Figure 3

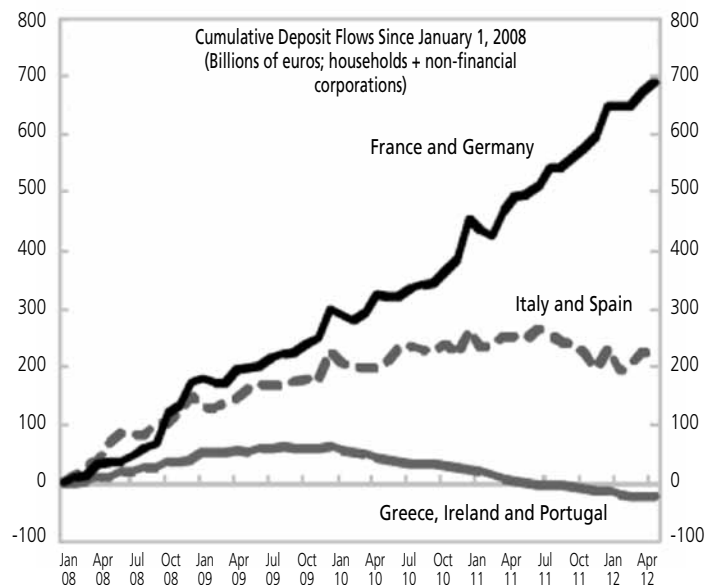
fragmented banking system, with evident risks for the financial stability of the monetary union.

Confidence in the Spanish banking system hit rock-bottom in May 2012, with the implosion of Bankia, Spain's third largest bank. Forced to restate its 2011 financial statements and admit to extraordinarily high asset devaluation losses, Bankia required urgent intervention and recapitalisation by the Spanish state.

Several elements of the Bankia crisis accounted for the loss of faith in the Spanish banking system and led to a bailout request. Most important was the extraordinary revision of Bankia's earnings statement for 2011: the 2011 profit of 300 million euros declared in March was reformulated a month later as a loss of 3 billion euros, due to asset impairment not acknowledged in the initial set of accounts. An about-turn of this magnitude, by no less than the third largest bank in the Spanish banking

sector, with more than 300 billion euros of assets, inevitably inspired profound distrust regarding the true state of the Spanish banking system. Additionally, the fact that Bankia was created by merging seven institutions – five minor savings banks and the second and third largest savings banks in Spain in terms of assets – cast serious doubts on the consolidation process that had been under way in Spain for the previous two years.

These three ingredients – a major bank in deep trouble, doubts about the veracity of financial statements and a questioning of the savings bank consolidation process – left the Spanish banking system facing an unprecedented crisis of confidence that implied nothing less than system-wide risk. This contrasted strongly with the previously transmitted message of a localised problem that affected a mere handful of weak institutions.



Source: European Central Bank.

Figure 4

The Bailout and Its Conditions

The loss of faith in the Spanish banking system came at a time when, as we explained in the previous section, Spanish banks had emerged as the principal, indeed, almost the only buyer of Spanish public debt. This added in a dangerous aggravating factor to the adverse feedback loop between bank risk and sovereign risk.

The consequences for market perceptions of the two risks were devastating, with negative repercussions for Spain's possibilities of rolling-over matured debt. The Spanish risk premium shot up, for the debt of both the Treasury and the largest banks in the system (the only debt for which an active secondary market existed). In fact, a remarkable feature of this situation was the close correlation between bank risk and sovereign risk premia, arguably the main element in the adverse feedback loop between the two types of risk.

But even more worrying than the increase in risk premia in the secondary market was the collapse of the primary (new issue) market: the Treasury was barely able to place 10 billion euros a month between March and June of 2012, compared to the 20 billion euros it had managed to place monthly towards the end of 2011 and in early 2012. Even more dramatic was the situation for Spanish banks, frozen out of the financial markets and unable to perform any operations at all between April and July.

Locked out of the markets and with a 150 billion euro funding requirement looming in the second half of 2012 (approximately two-thirds corresponding to the Treasury and one-third to the banking system), Spain had no choice but to apply for financial aid – a bailout – to shore up its struggling banking system and, in late June 2012, the Eurogroup approved credit for Spain amounting to a maximum of 100 billion euros.

The Memorandum of Understanding (MoU) for this bailout, signed in early July 2012, included a number of key requirements regarding restructuring of the Spanish banking system, virtually all of them to be implemented in the second half of the same year. These requirements focused on five core issues:

- Identification of capital needs through a comprehensive asset quality review of the banking sector and a bank-by-bank stress test.
- Development of a new legal framework to enable bank restructuring and resolution – including burden sharing for hybrid capital holders – as a way of reducing the net amount of the capital injection.
- Segregation and transfer of impaired assets to an asset management company, not to be consolidated with transferring banks or with the public sector.
- Capital injections to banks in need after burden-sharing exercises and transfer of impaired assets to the AMC.
- Development of restructuring plans for banks receiving capital injections, to be approved by the European Commission.

Progress with the MoU requirements to the end of 2012 will be analysed in Section 7. First, in keeping with the timeline of milestones in Europe's and Spain's finances, we shall now describe two important ECB actions of July and August 2012 that proved crucial to restoring, at least partially, confidence in the Eurozone.

A New ECB Manoeuvre: OMTs

The actions of the ECB need to be framed in the context of Eurozone tensions unfolding since the spring of 2012 in both public debt markets and in the fragmented Eurozone banking

systems. As already mentioned, the Spanish banking system was a major focus of concern, but not the only one, as Italy was also experiencing severe pressures on its public debt (the spread with Germany exceeded 4.5 per cent in July). In general, the risk premia for banks in all European countries (including the core countries) were being squeezed, especially because of their holdings of peripheral country debt. In fact, the risk of a breakup of the euro peaked in late June–early July, according to some unofficial betting houses.

Against this background, the ECB adopted two important measures in July and August. First, it reduced its intervention rate from 1 per cent to 0.75 per cent, while relaxing collateral requirements for access to its main refinancing operations (MROs). This measure had a positive impact, as it enabled banks to avail themselves of further funding by the ECB at reduced cost and so enhanced the spread on their carry-trading operations.

But the measure that had the greatest impact on markets was the announcement that the ECB would engage in outright monetary transactions (OMTs) in the secondary market to purchase the sovereign debt of European countries. The purchased bonds would have a maturity of up to two years and there would be no limits on the size of the operations. This decisive message was well received by the markets, with a general easing in risk premia; in Spain, the reduction was in the order of 1.5 percentage points for both government bonds and major bank debt.

However, the greatest impact of the announced OMTs was the immediate upturn experienced in the new issue market. Monthly issues of Spanish Treasury bonds, which had fallen sharply between April and June, increased significantly after the announcement of the OMTs,

to the point that the Treasury was able, in the second half of 2012, to place more debt than it needed to cover its requirements for maturing bonds and deficit financing (**Figure 5**). This meant that it had accumulated a liquidity cushion of almost 40 billion euros with which to face maturities falling due in early 2013.

Not only did the Spanish Treasury's debt issue capacity increase, but the profile of the investors who flocked to the debt issues also changed, with residents now accounting for a lesser share. The announcement of the OMTs thus had the effect of reversing a downward trend in debt purchases by non-residents.

Furthermore, if the OMTs have been crucial for providing finance to the Spanish Treasury, they have been even more critical for the Spanish banking system. After more than four months of financial drought, Spanish banks were able to issue debt amounting to over 25 billion euros in the last third of 2012, enabling them to roll over a significant proportion of debt maturing in that period and also to reduce their requests to the Eurosystem. The fact that not all banks could tap the financial markets, however, was clear evidence of segmentation. One of the objectives of the restructuring plan was therefore to ensure that the problems of a handful of entities did not become system-wide.

Bank Restructuring within the MoU Framework

Bank restructuring progressed in line with a pace established by the MoU for 2012, specifically regarding new regulations and the actions of the financial institutions themselves.

Regarding new regulations, Royal Decree-Law 24/2012, approved on 31 August (the deadline set by the MoU), laid the foundation

for a bank restructuring and resolution framework and for the creation of the asset management company, to be known as SAREB (Sociedad de Activos Procedentes de la Reestructuración Bancaria). This decree-law was later deployed via Law 9/2012 and Royal Decree 1559/2012, respectively. The new legislation was instrumental in ultimately reducing the final bailout to an amount far smaller than the initially approved maximum of 100 billion euros.

Stress tests that addressed adverse scenarios were carried out on a total of 17 banks (representing 90 per cent of the total assets in the system). The maximum capital shortfall was estimated to be in the order of 54 billion euros, distributed among four groups, as specified in the MoU:

- Group 0: Banks with sufficient capital to deal with the adverse scenarios addressed by the stress tests, namely, Santander, BBVA, Caixa-bank (including Banca Cívica) Kutxabank, Sabadell, Bankinter and Unicaja.
- Group 1: Banks already mostly owned by the public sector (via the Fund for Orderly Bank Restructuring, or FROB) and with the greatest need for equity (46 billion euros), namely, BFA-Bankia, NovaGalicia Banco, Catalunya Banc and Banco de Valencia.
- Group 2: Banks unable to meet their existing capital shortfalls without recourse to state aid, namely, BMN (Mare Nostrum), CEISS, Caja3 and Liberbank (estimated capital requirements 6.2 billion euros).
- Group 3: Banks identified by the stress test as able to meet existing capital shortfalls from private sources (that is, without recourse to state aid) through liability management exercises, asset disposals and capital

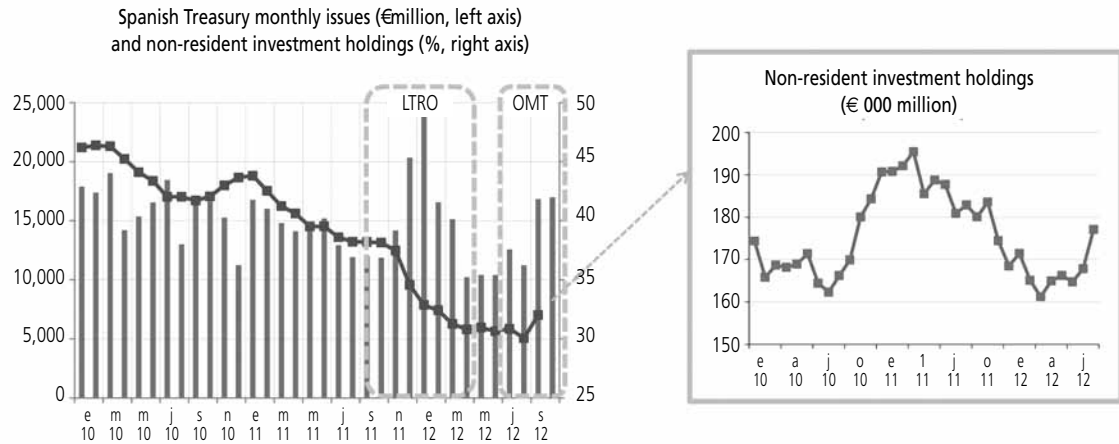
raised in the financial markets. This group is composed of just two banks, Banco Popular and Ibercaja (total requirement 3.4 billion euros).

Once banks were classified in these groups, real estate loans and assets from foreclosures, valued at around 63,000 million euros, were transferred to SAREB, thereby freeing up capital for Group 1 and Group 2 banks.

To be able to absorb this quantity of assets, SAREB was created with funds of its own (equity and subordinated debt) amounting to 5 billion euros, equivalent to 8 per cent of total assets. Also in accordance with the requirements of the MoU, SAREB shareholders are mostly private (55 per cent) – mainly Group 0 banks, other entities without capital needs (primarily credit unions), foreign banks with a presence in Spain and insurance companies.

Another MoU requirement was for banks needing capital to perform liability management exercises, allocating losses to the hybrid capital holders of their preference shares and subordinated debt. The underlying philosophy is that losses are borne by holders of shares in the rescued banks and of the above-mentioned hybrid instruments, thereby minimising the amount of capital to be provided by the public sector.

The burden-sharing exercises and the transfer of assets to SAREB resulted in a reduction of around 14 billion euros in the capital shortfall as initially estimated. To the final figure of 39 billion euros should be added an amount of just under 2.5 billion euros needed to bring FROB's share of SAREB to 45 per cent. The final total of 41.5 billion euros was therefore well below the 100 billion euros initially approved by the Eurogroup.



Source: Afi, ECB, Banco de España.

Figure 5

Outcome: A Supervised and Highly Concentrated Banking System

The MoU states that European Commission approval of aid to the Spanish banking sector is conditional on radical restructuring of the institutions receiving assistance. The most stringent requirements are imposed on the Group 1 banks, as major recipients of aid (37 billion euros); these requirements include capacity reduction (in branches and people), »withdrawal« to their home markets and rapid deleveraging to enable them to balance loans and deposits.

A number of corporate operations have been concluded, such as the sale of Banco de Valencia to Caixabank and Caja3 to Ibercaja. This process will continue in the coming months, when it is planned to auction several of state-aided banks – although not Bankia (given its size) or BMN and Liberbank (given the intention eventually to list them on the stock exchange).

The result – and endpoint for the moment – of the restructuring process accelerated by the MoU is a map with just ten entities in the place

of the former banks and savings banks (the distinction is hardly valid any more), accompanied by a large number of rural banks and credit unions as the only banks continuing to adhere to the principles of proximity banking and territorial affiliation.

One final consideration refers to another key element that has been at the forefront of the negotiation process for the bank bailout, namely, the possibility of direct capitalisation from European funds versus capitalisation through FROB. If the source of the problem is the aforementioned adverse feedback loop between bank risk and sovereign risk, then the most effective way to break that loop is to bypass the Spanish public sector as a guarantor of banking risks and directly capitalise banks from Europe.

However, the European position is that this would be feasible only within the framework of a fully operational banking union, or, at least, of effectively implemented EU-wide banking oversight. Since progress in this regard has been much slower than expected, with banking oversight not due before 2014, Spanish banks will

of necessity be recapitalised by FROB. Since FROB will assume the debt to the EU and will acquire shares in the capitalised banks, the link between banking risk and sovereign risk is re-

tained, meaning that any losses on asset disposals or on the restructuring of state-aided banks will be borne in their entirety by the Spanish public sector.

APPENDIX. SUMMARY OF FINANCIAL MEASURES		
EUROPE/EUROZONE	2011	SPAIN
<ul style="list-style-type: none"> • Europe-wide bank financing crisis (Spanish and Italian but also French for the first time) • US Federal Reserve swap lines • European fiscal agreement, opposed by the UK 	August	
<ul style="list-style-type: none"> • ECB: LTRO1 (€500 billion) 	December	
	2012	
<ul style="list-style-type: none"> • ECB: LTRO2 (€500 billion) 	January	
	February	<ul style="list-style-type: none"> • Royal Decree-Law 2/2012: Provisions for impaired property asset risk
<ul style="list-style-type: none"> • France loses AAA rating 	March	<ul style="list-style-type: none"> • Acknowledgement of budgetary difficulties
	April	<ul style="list-style-type: none"> • Royal Decree-Law 18/2012: Additional provision for property asset risk (impaired and standard) • Intervention in Bankia
	May	
	June	<ul style="list-style-type: none"> • Sovereign and bank ratings downgraded three notches from A+ to BBB (and lower) • Application for financial assistance for banking sector
<ul style="list-style-type: none"> • Eurogroup: €100 billion credit line approved as financial aid for Spanish banks 	July	<ul style="list-style-type: none"> • Memorandum of Understanding signed • Stress tests: Top-down
<ul style="list-style-type: none"> • ECB: OMTs announced • Base rate reduced (1% → 0.75%) 	August	<ul style="list-style-type: none"> • Royal Decree-Law 24/2012: New framework for restructuring and resolution of financial institutions
<ul style="list-style-type: none"> • ECB: OMT details • EC: First banking union proposal 	September	<ul style="list-style-type: none"> • Stress tests: Bottom-up
	October	
<ul style="list-style-type: none"> • Restructuring and resolution for Group 1 banks approved 	November	<ul style="list-style-type: none"> • Law 9/2012: Restructuring and resolution of credit institutions • Royal Decree 1559/2012: Asset management company
<ul style="list-style-type: none"> • Disbursement of the first tranche of aid to Spanish banks (€37 billion) • Approval for restructuring and resolution for Group 1 banks 	December	

Technology, Competitiveness and Sustainability in Europe

Innovation and Competitiveness: Two Sides of the Same Coin

Regino Moranchel

New Horizons for Europe

In the midst of an economic crisis and confronting a bleak global landscape in which most key actors are non-Community members, the EU is facing a complex and uncertain future. Europe is experiencing an unprecedented economic and financial crisis while attempting policy changes it hopes will prevent it from falling behind in the global race for growth and competitiveness.

Leading firms in technological development understand the challenges of innovation and the consequences of failure; it goes beyond becoming competitive, it is about ensuring survival. They also understand, as actors in the international arena, that companies must play a key role in driving innovation forward in the face of ever-increasing global competition.

Innovation is not just about generating new ideas and undertaking new research. It is about ensuring that innovative ideas are converted into products and services of market value that can create new sources of growth. Indeed, this is the main objective of the Innovation Union, a

Europe 2020 flagship initiative, going forward over the next few years.

Without a clear and effective commitment to innovation not only are we putting the recovery of the economy at risk, but we are risking our long-term ability to compete in this globalised world. We are dangerously close to a point from which there may be no return. What we need to understand is that we are not only risking a lot, we are risking it all.

Fortunately, there seems to be a general consensus within the EU that innovation is more important now than ever and that the challenges of climate change, energy, food safety, health care and ageing populations demand new and innovative solutions.

Looking back, the EU has made great strides in innovation performance over some two decades of innovation policy. But although in 2011 most member states improved their innovation performance, more recent reports (the Innovation Union Scoreboard and the Innovation Union Competitiveness report) highlight the decline in European research and innovation efficiency in recent years.

Europe looks on in concern as the international leaders, United States and Japan, continue to widen the innovation gap, particularly in terms of leveraging private investment and in the United States, in terms of top-end research. And there is more bad news for an already beleaguered EU; while it maintains a clear lead over the emerging economies of China, India and Brazil, these countries are moving fast, showing improved performance and gaining ground every day.

Another area that does or should concern the EU is the uneven pace of development among member states. Not only do budgets for innovation and education vary greatly between countries, but so do innovation systems and the innovation activities of businesses, the latter considered a key factor in achieving top positions at EU and international level.

Between the EU27 innovation leaders (Sweden, followed closely by Denmark, Germany and Finland) and the modest innovators (with Lithuania straggling behind Bulgaria, Latvia and Romania) are the remaining 19 states. These can be divided into the innovation followers, who aspire to leadership positions, and the moderate innovators, which include Spain in a poor eighteenth position.

It is clear that the EU must make more effort to boost innovation if it is to close the gap with the United States, Japan and South Korea and to emerge in the best possible shape from the current crisis. We must not lose sight of the fact that there are new paradigms in play.

Start-ups in other parts of the world are enjoying a success unimaginable in Europe's current climate. We should also acknowledge that many European companies continue to demonstrate that they can be drivers and key to the success of their innovation ecosystems.

When referring to effort, I am referring to strategic effort. It is not just about investing in

innovation, it is about doing it right. We must restructure our national research and innovation systems, achieving balance, and offer companies an innovation-friendly environment for business.

Restructuring would make sense only in the context of a European Research Area which, according to Maire Geoghegan-Quinn, European Commissioner for Research, Innovation and Science, would inject fresh competition, generate more excellence, and attract and retain the best global talent. The urgency of both questions, the restructuring of systems and the completion of a European area, is certainly beyond doubt.

Naturally, top-ranking states have worked hard to gain their positions. The most positive factors correlate strongly with robust national research and innovation systems, with regard to which business is a key player, along with public-private collaboration.

All innovation leaders – Sweden, Denmark, Germany and Finland – perform excellently in research and development expenditures, as well as in other innovation indicators related to company activities. Top EU innovation performer Sweden, for instance, dominates in human resources, finance and support and firm investments; while Germany and Denmark perform best in linkages and entrepreneurship and intellectual assets vs. innovators and economic effects. European top innovators also do well in marketing their technological knowledge and were the most successful at becoming internationalised.

The largest gap appears in the »Firm activities« category where the EU27 lag behind in business R&D expenditure, public-private co-publications and, with regard to the United States, in excellent and attractive research systems. Improved framework conditions for innovation will not suffice if the EU is unable to at-

tract many more top researchers and young scientific talent from abroad.

Realising we are in a critical preparatory phase ahead of the adoption of the first measures for the next EU Framework Programme Horizon 2020 from 1 January 2014, the State of the Innovation Union report from the Commission states that all actors should now be taking collective responsibility for Innovation Union delivery, adopting the proposals tabled by the Commission and converting political commitments into decisive action, at both national and EU level.

A number of pilot schemes have already been launched and tested, with varying degrees of success. Public consultations have shown there is special interest in a variety of questions, including the future of research and innovation funding in Europe, the European Research Area and modernising public procurement policy. Although pilots are extremely valuable, there is an overriding imperative to turn proposals and agreements into concrete action.

We cannot afford to squander our opportunities at this critical stage, in the transition from one strategic approach to another. And at a global level, there is no shortage of opportunities. But we cannot afford to repeat earlier mistakes, the indecisiveness and limited participation of stakeholders that spelled failure for the Lisbon Strategy. The building of Europe as a knowledge-based economy was never completed and R&D&I objectives never achieved.

The new Europe 2020 Strategy revisits some of the core Lisbon objectives, adding new ones designed to develop Europe's competitiveness, technological development and innovation capacity and allow it to better compete in the new international landscape. We now have a strong imperative to act.

Positive progress has also been made on the question of grants. In addition to red tape, the

main stumbling block for companies is poor access to funding. Public funding should be used as a means to leverage private capital and, although the EU Competitiveness and Innovation Programme has boosted investment for thousands of companies, it falls short of requirements. European venture capitalists continue to invest substantially less than their US counterparts (some €15 billion less). Innovation Union proposals for a new cross-border venture capital regime and cooperation with the European Investment Bank to expand existing financial instruments in the EU, such as the Risk Sharing Finance Facility (RSFF), are certainly moving Europe in the right direction.

Another area of concern for companies is public procurement policy. At this time, we must obviously be very rigorous in the spending of public money. Investments are expected to generate added value more efficiently and public institutions are being streamlined, the natural result of increased cost-efficiency. But two billion euros are spent annually by the public sector on supplies, personnel and services. Of this, very little is spent on innovative products and services; this extremely ineffective use of public procurement represents a lost opportunity. Lack of incentives, weaknesses of education and training systems and the fragmentation of demand are the main causes. It is thus very positive that the new Framework Programme sets out to offer financial help to all EU administrations to facilitate the development of innovation instruments, such as innovation plans.

The time has come for public administrations, such as that of Spain, to seize the opportunity and complete their modernisation process by introducing innovation which, ultimately, will lead to cost-saving.

But over and above these matters of concern, there is a general preoccupation among the public, also seen in the European business

community. Citizens lack confidence in European and national policies and assume they are doomed to fail. Even more alarming, there is disaffection and lack of trust in institutions, organisations and their leaders, in both the public and private domains.

In other words, what hangs in the balance is not only economic recovery, but public confidence in the ability of the EU to safeguard the welfare of European citizens, now and in the future, not to mention in the poor capacity of governments and political leaders to manage the crisis and work together to overcome it. The financial system has lost all credibility because of its role in instigating the crisis and the uncertainty surrounding the recovery. There is even a lack of confidence in the European business community, especially large companies and their ability to act as a demand-pull for future growth. Never before has it been as important that we work to recover our confidence, both at the individual and collective level.

We must be realistic, acknowledging our strengths and competitive advantage but also our weaknesses. This also goes for the business community.

By Way of a Diagnostic

The latest Commission report on company innovation *The 2012 EU Industrial R&D Investment Scoreboard*, based on data from 2011, allows us to reflect on the health of European companies and their capacity for innovation. First, the ranking highlights that economic competitiveness depends not only on pure innovation muscle (amounts invested in R&D), but on the technological features of our companies.

In 2011, R&D investment by EU-based companies (including foreign companies based in

the EU) amounted to €144.6 billion or about one-third of the €510 billion invested by the 1500 Scoreboard companies around the world (equivalent to almost 90 per cent of total expenditure on R&D by businesses worldwide). These amounts were less than those invested by US companies (€174.8 billion) and more than those invested by Japan (€111.5 billion).

The R&D one-year growth rate nearly matches that of US companies, at around 9 per cent. However, it is significant that this »muscle power« has not been turned into a corresponding sales and profits growth: North American companies more than doubled European growth in both these areas. In other words, our US counterparts are better at turning innovation investment into economic growth and capture more value with a similar economic effort.

Delving deeper into the data, we find that of the 37 sectors under consideration, the top five sectors in terms of R&D investment – in this order: Pharmaceuticals and biotechnology, Technology, hardware and equipment, Automobiles and parts, Software and computer services, Electronic and electrical equipment) attract 65 per cent of the total. This is clear evidence that there is a high concentration of investment in some sectors and it is significant that precisely in those sectors is where only 35 per cent of all European firms operate versus a much larger 62 per cent of US companies. If we consider just the top three sectors, we find an even more pronounced difference with only 22 per cent of European firms operating in these sectors versus 42 per cent of their US counterparts (remember the top three investors by sector out of 37 sectors), representing 50 per cent of the €510 billion total investment.

This data clearly explain why Europe continues to lag behind the United States in investment volume and R&D intensity. US firms are

able to achieve better innovation performance because of their relative specialisation in technology-intensive sectors. By contrast, only 37 per cent of EU companies invest in these sectors.

It appears, therefore, that the fabric of American industrial innovation is better oriented to convert research effort to real competitive advantage. This is down to the fact that the sectoral composition of the US economy is based on an understanding of the areas that have the greatest technological potential. Another probable factor is that there is greater tolerance of entrepreneurial failure in the United States and the sectors we are looking at are the riskiest and least certain. In effect, European companies suffer from too much fragmentation and are unable to achieve critical mass, with consequential limits to growth performance.

It is worth noting that out of the 405 companies based in the EU, only 14 are in Spain. Overall, major EU-based firms continue to rely on R&D for their competitive edge. As already mentioned, EU companies substantially increased their total R&D investment to almost 9 per cent in 2011 (up from 6.1 per cent in 2010). This increase beats the global average (7.6 per cent) and is far ahead of Japanese companies (1.7 per cent). Moreover, high R&D-intensive sectors tend to show above-average growth.

Another key factor is the location of companies since, according to evidence compiled in the EU and by the OECD, multinationals tend to invest around 80 per cent in the region where they are registered. Therefore, Scoreboard data correlate quite closely with private sector R&D investment trends in each region of the world.

Any analysis must include a look at high-performing companies in terms of their sales and profit. Worldwide, companies who have doubled their sales in the past decade operate

in two main sectors: ICT (such as semiconductors, telecoms and software) and health-related (such as pharmaceuticals, biotechnology and medical equipment). In terms of profitability, software and computer service companies combined high performance in terms of sales with higher levels of profitability (almost 30 per cent).

Among the top 50 high-performers on the basis of sales performance, eight are based in the EU. The top sectors in terms of R&D investment are automobiles and parts and pharmaceuticals and biotechnology. Also in the EU, the Banking sector shows the highest investment growth (a 19.5 per cent increase), followed by automobiles and parts (16.2 per cent) and industrial engineering (15.6 per cent).

The EU continues to be an attractive location for R&D investment from foreign-owned companies, however, and any R&D investments made by EU companies outside the EU are positive for Europe and are not made to the detriment of their investments within the EU.

In terms of foreign company investment in the EU, it is worth noting that, despite the new competition and scientific and technological leaders appearing in the emerging economies, Europe remains the main region for foreign R&D investment for US companies. Europe has a number of considerable strengths, of course, including developed markets with sophisticated demand («lead markets»), the quality and quantity of its skilled labour, public support for R&D and the quality of its scientific and technological base. There are also the reforms to our research and innovation system in line with the first EU Lisbon Strategy and then the Europe 2020 Strategy.

With regard to the second point, I fully endorse undertaking research and development activities outside of Europe. By becoming more international, our major companies – particu-

larly those involved in technological innovation – can only be setting a good example. Companies should be trying to ensure that their value chains are developed globally in all aspects (design, production and sales). The opening of new markets and the expansion into more geographical regions will depend on our doing our own research, development and innovation activities beyond Europe's frontiers.

Not only would Spain and Europe benefit from broadening their access to new knowledge bases, but any R&D&I – indeed, all R&D&I, whether in Spain or abroad – is complementary. In fact, taking all European companies together, there is no indication that any R&D&I activities of EU companies outside Europe lead to less R&D&I in member states at the aggregate level.

European R&D Policy

This is not the place to go into detail on European programmes as the principles and objectives of the Europe 2020 Strategy and its flagship initiative, the Innovation Union, are well known and have been widely debated elsewhere.

Let us concentrate, then, on the key programmes for business contained in the proposals of the Commission for the forthcoming Horizon 2020 programme, currently under negotiation. Under the terms of the proposed support it will represent a major boost and motivation for companies to participate in international cooperation and will mean:

- Combining the principal sources of European funding into a single instrument, through the Competitiveness and Innovation Framework Programme (CIP) and the European Institute of Innovation and Technology (EIT), simplifying access to European funds and fa-

cilitating lines of continuity for financing ideas and projects through the different stages of design.

- Improved funding conditions: the funding percentage for major companies will increase from the current 50 per cent to a minimum of 70 per cent.
- Standardisation of indirect cost models, applying a single flat rate of 20 per cent across the board. Companies with efficient cost structures and, therefore, lower indirect costs would not be adversely affected in the competition to obtain funds compared with companies with very high percentages (some over 50 per cent). We are aware that this particular point is the subject of some controversy at the moment.
- Reducing audits, using new models based on the good faith of participants.
- Ensuring that Framework Programmes and other funding instruments, such as the Cohesion Fund, are compatible. Currently, they are incompatible.
- A simplification of procedures for applying, negotiating and justifying to tackle the currently complex and bureaucratic system.
- A significant reduction in access times for funding. Under the present framework, waiting times are often over a year from application to receiving the grant and 6–9 months in exceptional cases.
- In terms of different models of association, we generally believe in allocating funds based on competitive calls and selecting on innovation excellence. This is achieved through Public Private Partnerships where funds are managed by the Commission or public bodies. Large R&D budgets are not employed on pre-allocated restricted groups of companies, as in the Joint Technology Initiatives (JTI). As a company, we accessed

funds through both initiatives and this experience leads us to support the petition of those states proposing the standardisation of both models (PPPs and JTIs) and favour PPP as the new model.

- Positive emphasis on actions close to market rather than new areas of research, through the use of pilots, demonstration and trial banks allowing shorter investment return times and minimising the so-called Valley of Death impact (getting from prototype to marketable final products).

A qualitative analysis of EU R&D&I policies, strategies and programmes must include a study of the current targets of member countries in relation to EU programmes and policies.

If we analyse in detail the data on returns per country for each of the EU member countries and the efforts of R&D&I agencies, the results are cause for concern. It appears that individual countries aspire to or have an overarching aim not to attain R&D&I technological development or enhance competitiveness for its own sake, but rather to ensure that their national R&D&I ecosystems recoup as much funding from EU programmes as the amounts they originally contributed to the R&D&I.

There are two predictable consequences of this: first, member states cut back their innovation effort once they have achieved the expected returns; and second, countries can lose sight of the strategic value of R&D&I and, in some cases, obtain resources for non-strategic sectors at the expense of strategic ones.

The countries which will have obtained greater returns from the VII Framework Programme compared to their contribution to the Community budget during the period are Estonia, Finland, Sweden, Greece, Cyprus, United Kingdom, Austria, Slovakia, Denmark and the Netherlands.

In the case of Spain, the returns on R&D&I are not aligned to the strategic or priority markets defined in R&D&I policy. Health care, for instance, is a priority area but the returns on its R&D&I programmes do not reflect its importance in respect of other sectors, according to the Report on Spanish Participation in the VII R&D Framework Programme of the EU, drawn up by the Centre for the Development of Industrial Technology in Spain (CDTI).

The R&D&I effort must be closely aligned and synchronised, not only to facilitate the implementation of European plans and objectives but to give expression to the common governance of the EU and its member states.

As part of this in-depth study of European programmes from the business point of view, two key questions come to mind. First, to what extent have European programmes actually helped companies boost their technological development and enhance competitiveness and, second, has that improvement been proportional to the economic effort made by the EU in this area?

From the business sector's point of view, projects under EU programmes have clearly helped to improve the R&D&I and competitiveness of EU firms. It is also true, however, as we concluded from the 2012 Industrial R&D Investment Scoreboard in relation to EU firms, that the results of that effort fell short of expectations. Our hypotheses is that the best use of funds is not being made because too few R&D&I projects are making it to the market. One reason for this could be that there are no metrics or systems to monitor the utilisation or spread of projects financed by the EU. As a result, innovation and productivity are not being sufficiently leveraged in relation to the funds employed.

In short, there is a clear need to support projects which have a real application in the mar-

ket. Given that there are no metrics to measure this, clearly the best means the EU currently has to support it is public procurement of innovation. In this way, administrations undertake to procure innovative products and services, benefiting society as a whole and European companies in particular, as they endorse and boost new innovative products and services.

Closely related to this thought is the choice of pilots and demonstrators for projects benefiting from R&D&I funding. Clients demonstrating clear functionality should be carefully selected for easy application to other fields, contributing to the mainstreaming of technology and enhancing the competitiveness of the EU. It is currently difficult to see the utility of many R&D&I projects because many have limited application and are difficult to roll out.

Knowledge transfer from the scientific to the business community is undeniably a priority and in terms of the value chain could be reinforced by ensuring that there is a real conversion of R&D&I projects to market products. This is because the ultimate aim of innovation is to create new and/or improve existing products and services. Research and innovation resulting from EU or national projects has to make it to the market and not just stay on the shelf.

There is also the question of consortiums. Are they the best means of working together on projects commissioned by the EU?

It is our belief that we must act fast and proactively in response to current and future needs. This was the idea behind the consortiums set up to deliver projects financed by EU programmes. Indeed, the current rules for EU research, development and innovation programmes make it easy to collaborate and contact all agents within the innovation ecosystems in each of the member states. However, these rules and mechanisms belong to a time when the overriding

priority was to facilitate closeness and distribution of knowledge between member countries of the innovation ecosystem and help break down cultural barriers. The question now in our ever more global and connected world is whether this model of collaboration is still the most effective.

We in the private sector think that collaboration and cooperation between all agents is clearly important. However, perhaps there should be no fixed number of members or countries represented, relying instead on the competitiveness of different agents to carry out specific initiatives. This would certainly simplify management and minimise the potential risk surrounding projects because obstacles to progress can often be attributed to consortium management rather than technology or innovation factors. Either way, regulations on collaborative and cooperative work should ensure that resultant products reach the market and this is possible only where there is active participation and effective collaboration between consortium members.

In order to make innovation cooperation a reality, we need to ensure there is real commitment and effective collaboration between all R&D&I agents in Europe. This would promote the model of Open Innovation, with all its degrees of freedom, no restrictions, no limitations, helping to build a truly innovative and competitive knowledge network and ecosystem. In a world of open innovation, the boundaries between a firm and its environment become more permeable in terms of collaboration, knowledge generation and sharing. We will be able to understand the real and immediate needs of clients, while anticipating future demand in order to stay at the forefront of technology.

This analysis of European plans and research instruments would not be complete without a

final thought: the key innovation drivers are young talent and the education of Europe's young people. Analysing data from the Pisa reports that evaluate education systems worldwide, it is clear that there is an education divide even within member countries of the EU. The gap is ever-broadening despite the efforts of some states and is one of the main factors that led to the idea that there are three »wagons« in Europe, the Southern, the Central and the Northern.

The differences highlighted in student performance indicate that something is wrong. Education policy should not and cannot be generic but specific to each territory to effectively reduce the education gap. It is essential that education policies should take into consideration the same basic ingredients of scientific vocation, innovation, creativity and the enhancement of entrepreneurship, as well as try to address new societal demands. It is fine to attract foreign talent to Europe as long as we address the fact that our own developmental divide is contributing to a brain drain away from Europe. The social cohesion and equity that favour innovation and the enhancement of competitiveness in our own productive fabric is why we must place our citizens, and especially our young people, at the heart of any European strategy.

As European companies we should be contributing all our potential to the mammoth task that lies ahead. Our continuing participation in international R&D consortiums and internationally funded research and innovation programmes; our ability to collaborate with other companies using our value-added differentiation; our proactive involvement in the main European technological platforms, where companies can put forward their vision and interact with a variety of actors in the R&D&I Pro-

grammes; these are just some of the channels open to us to help get Europe back on the path of growth, with increased opportunities for employment creation and competitiveness.

Recommendations

- In the midst of the strife, we must not forget to act with conviction and use innovation as a tool to pull ourselves out of crisis. Europe and Spain are focusing too heavily on public budget constraints, the problem of the deficit, access to finance on the credit markets and the move towards fiscal union. But it is investment in innovation that is most likely to get us out of the crisis and allow us to emerge in better shape.
- We should redirect and engage our R&D&I activities to tackle major societal challenges, particularly those that affect EU citizens. Such a breakthrough would stimulate the scientific and innovative potential of the EU in areas that address the problems of society and currently demand an expensive R&D&I effort. These challenges, by their very nature and complexity, leave us no option but to apply our knowledge breakthroughs to technology, products and services that will enable European countries to grow and assume global leadership in science, technology and the market.
- The public administration of the EU and its member states must act to drive forward the technological development of Europe's productive fabric. Public procurement of innovative technologies is likely to boost R&D and address the challenges and requirements of EU citizens. By encouraging a more innovative and competitive European technological and industrial base we will ensure

output to other markets by European firms based on the differentiation of products and services of real concern (such as health care, social innovation and renewable energies).

- The close alignment of regional, national and European policies and strategies with a view to establishing synergies with strong multiplier effects on the innovation and competitiveness of the productive fabric of Europe. Moreover, in order to move forward and avoid duplication and fragmentation, it will be necessary to better link up research and innovation systems at a regional level within the EU, turning to account the sheer size of Europe by launching a pan-European digital transformation. It is worth remembering that the opening of the telecommunications market together with the development of common GSM standards laid the foundations for European success in mobile telephony. We should take positive action to boost pan-European clusters around collaborative innovation and articulate the mechanisms of transfer between the public and private sectors; we should provide incentives to researchers to get involved in entrepreneurial projects. Equally, it is necessary to push forward pan-European public–private collaborative projects to lever investment in innovative sectors, such as intelligent transport, energy management, renewable energies, biotechnology and digital health, undertaking the necessary investment and promoting transparency and risk-sharing in long-term projects.
- Collaboration between member states needs to work better. That means setting up an intra-European area that will facilitate the opening up of national R&D&I programmes to Europe. The public procurement budgets of countries with similar needs could be

pooled to facilitate collaboration, such as in the case of enhancing Mediterranean country border controls. Better collaboration would mean better synergy and would help reduce costly duplication in similar initiatives conducted separately by member countries. In turn, this would lead to a more effective development of innovative technology by the business sector and greater competitiveness of EU firms vis-à-vis their global counterparts.

- We need to work effectively with our international partners in R&D&I, not only within Europe but with other regions worldwide. For instance, Spain would be a useful ambassador for cooperation with LATAM or countries of the Pacific Alliance. Other areas of collaboration might include aerospace initiatives with Brazil or offshore wind energy in Chile.
- Encourage a common research area within the EU for member countries in which all countries adopt the same innovation legislation. This would level the playing field in terms of innovation and competitiveness between European countries and would, as a result, more objectively reward innovation and technological excellence.
- Specialisation of territories, allowing us to structure social and economic development to favour convergence based on the capabilities of Europe's productive fabric. This would also benefit the scientific expertise of its agents and boost innovation as the engine of change, enhancing competitiveness and productivity in the EU. That means more specialisation and better use of EU resources where the private sector would benefit from a coordinated approach to innovation, avoiding the current rivalry between territories and countries of the EU who are developing similar technologies in the same field.

- We must educate and train young Europeans so that their skills better match the needs and requirements of a changing society by encouraging and reinforcing scientific vocations and stimulating an innovative and entrepreneurial spirit from an early age. EU employment is currently growing and there are a number of profile requirements which are not being met. A similar trend can be seen in the USA. We must encourage creativity and eliminate the aversion to risk that affects young Europeans more than those in other areas.
- We must change society's perception of businessmen and women and businesses. We must encourage a culture that is scientific, innovative and entrepreneurial, which will permeate society at all levels and drive creativity forward. The entrepreneurial spirit needs more acceptance at a societal and institutional level.
- We must create European associations to mobilise and coordinate an over-arching approach to research on a European, national and regional level with the participation of all agents of the business innovation ecosystem. This should include public administrations, knowledge institutions, technology centres and interface organisations in both the public and private sectors. One example of this is the Future Internet Private Public Partnership (FI-PPP).
- Much remains to be done. Our final recommendation is also a reflection on matters of deep concern. We must be clear about the outcome of our innovation effort and know how projects undertaken have translated into real business. We must establish robust monitoring procedures throughout the life-cycle of our research and development projects. This is particularly relevant as we scrutinise the performance of projects paid for with public money. Investments must be made wisely and well. For each choice we make, there is a lost opportunity and a commitment of time which, once made, is irrecoverable. And time is something we have precious little of. Excellence must increasingly become the guiding principle in converting innovation into business competitiveness. To move forward, we need to judge the value of what we have been doing. As the ancient Greek aphorism admonishes us: »Know thyself«. It is the first step in redefining our vision and strategy.

The Common Agricultural Policy in 2012

Raúl Compés López, José M.^a García Álvarez-Coque

Introduction¹

Despite its steady loss of importance, the CAP remains one of the core community policies. In 2012, it accounted for around 41 per cent of the total budget. Even during the present period of severe economic and financial crisis, it is still central to the EU's political agenda. For Spain, it is doubly important, as the country continues to be the second-biggest recipient of agricultural funds.

The year 2011 ended with the submission of the European Commission's legislative proposals for the CAP for 2014 to 2020. According to the established timetable, 2012 was the year in which to negotiate these proposals in the European Parliament and in the Council, with a view to closing the negotiations in 2013, at least in the Parliament.

Lone Wisborg, the Danish ambassador in Spain, thought so too at the beginning of the

year, when she echoed the goals of the Danish presidency: the »hope and the plan is that at the end of the year there will be an agreement on the CAP«. Cypriot President Dimetris Christofias, after taking over the Presidency from the Danes, was more cautious, saying that his goal was to take the CAP reform »a step forward«, although he appeared to be convinced that it was possible to conclude the negotiations on the Multiannual Financial Framework (MFF) 2014–2020 before the year was out, as the European Council had agreed in June 2012.

Political Account of a Year of Transition

In practice, all those expectations proved vain. The lack of rapprochement with regard to the positions of the leading countries was accompanied by the failure to reach an agreement on the EU budget for 2014–2020 at the special meeting of the European Council of heads of state and government on 23 November, a situation that led several agriculture ministers, Spain's among them, to champion the advisability of the European Commission extending the CAP

¹ Some of the figures and arguments presented in this chapter use findings from the project »Sustainable Agri-Food Systems and Rural Development in the Mediterranean Partner Countries« (SUSTAINMED, FP7-KBBE-2009-3), partly funded by the EU Commission.

and the current budget to 2014, delaying the start of reform by a year.²

These problems were reflected in the debates in the European Parliament, the new player in the Community decision-making process on the CAP, which failed to come up with a clear position on the Commission's proposals and chose to postpone the definitive vote until after there was an agreement on the MFF. It was hoped that this would occur during the session of 23 and 24 January 2013 – in which case the vote in plenary could take place in March – and, in a show of greater optimism than that shown by the agriculture ministers, it was thought that, in spite of everything, the new CAP could stick to the agreed timetable and enter into operation on 1 January 2014.

Throughout this time, the European Parliament's position changed with each different report drawn up by the ComAgri (Committee on Agriculture and Rural Development) rapporteurs: George Lyon (July 2010), José Bové (September 2010) and Albert Dess (June 2011) – all of which were released before the Commission's proposals – and, referring to the Commission's legislative proposals, those submitted by Luis Manuel Capoulas Santos, Michel Dantin and Giovanni La Via (submitted between May and June 2012 on each one of the respective regulations), as well as the report by Paolo De Castro (September 2012) on the MFF. Generally speaking, a great many amendments were submitted – nearly 7,500 from the ComAgri alone: 2,292 on direct aid, 2,227 on the single CMO, 2,217 on rural development, and 769 on horizontal regulation – but there were few original

key ideas concerning the political framework defined by the Commission's proposals.

And it is curious that, although this time the process had been more open and participative than ever,³ from the moment they were presented in October 2011 the Commission's proposals triggered almost across-the-board rejection, with the exception of some token groups or agencies linked to one specific sector, for example, the European Sugar Users Association (CIUS). This lack of imagination or ambition among the Community powers confirmed not only the institutional inertia brought about by path dependence, but also the power of the Commission to mark out the playing field in a convenient, usually moderate terrain, a strategy so dear to the EU's political customs.

There had been some inkling of this already in the document »The CAP and Horizon 2020« from 2010, in which, while the starting point was relatively open, it was possible to make out the Commission's intention of leading the reform to an intermediate path, far from a total overhaul or other political adventures. Although this steady pragmatism is often a commendable and understandable Community trait, there was a clear desire to preserve the status quo in the proposals – even the Court of Auditors pointed it out (Opinion No 1/2012). The main initiative consisted of shifting the single payment scheme to a new range of payments, all of which were to be developed in the future.

Since the general framework could not, or would not, permit a thorough review, the debate ended up drifting towards the many technical

² It is only fair to state that the Court of Auditors had come to the same conclusion in April, although its argument was that the paying agencies would need approximately 24 months to adapt to the new procedures.

³ With interesting milestones that went from the public consultation initiative launched by Ciolos in April 2010 to the eCAP Platform created by the Department of Agriculture of Catalonia to facilitate citizens' contributions, taking in the Questionnaire on the CAP drawn up by the Ministry of Agriculture, Food and the Environment.

details that appear when reforming such a broad policy, which ultimately succumbed to national and industry interests. Against this backdrop, it is hardly surprising that, bearing in mind the high degree of national and product differences within European agriculture, and the power of the forces that are reluctant to change the status quo, there was practically every possible position on almost every issue: »greening«, direct aid and, of course, the CAP budget for 2014–2020, to name just a few of the most controversial and significant.

As far as »greening« was concerned, it was surprising to see the British minister for rural affairs – who favoured a »productive agriculture« – aligned against it with, among others, his French and Dutch counterparts, albeit for different reasons. Should the present proposal as an obligatory payment in the first pillar be maintained, the Commission will have to be more flexible so that farmers can choose from a broader range of green measures in order to modulate down the 30 per cent of funding linked to environmental performance.

As regards direct payments, there was no agreement on the scale and pace of convergence on the basic payment scheme, or on the eligible hectares. Each country's position depended on its agricultural budget balance, its method of applying the single payment scheme and the development of areas that could be eligible. Net contributor countries, such as the Netherlands, are asking for the principle of equivalence, not of proportionality, to be applied, so that all the member states with above-average payments make comparable contributions. It is also asking for a regionally-based payment system. This stance, which ultimately sought to soften and to delay the negative impact of redistribution, both internally and externally, was followed by countries such as Ireland

and even Spain, whose payments per hectare are slightly below the Community average, but with considerable internal differences.

Lastly, the main stumbling block was the lack of agreement on the MFF. European Council President Herman Van Rompuy's proposal involved a cut of some 68 billion euros in the budget submitted by the Commission (–6.7 per cent), of which almost 25 billion would come out of the CAP (a 5.7 per cent reduction for the first pillar and a 9 per cent cut for the second pillar). The proposal was unacceptable to the French – the main beneficiaries of the CAP – who were backed by the Spanish. Talks were to resume in 2013, with a fresh offer.⁴

Other significant issues and news concerning the Common Agricultural Policy in 2012 were the 66 per cent reduction in agricultural fraud in 2011, according to the Commission report »Protection of the EU's financial interests«; ongoing debates on the system of sugar quotas – with a proposal by France and Germany to extend the beet/sugar quota system to 2020 – and discussions on the system of vine-planting rights (with another proposal to maintain them from France and Germany), as well as the presentation of a legislative proposal for organic agriculture.

The International Dimension of Agricultural Policy in the EU

The reform of the CAP is not just an internal issue. The current subsidy model, introduced in 2003 and based on a decoupled single payment per farm holding, is closely tied to external

⁴ It must be taken into account that the Commission proposal already represented a reduction of more than 9 per cent compared with expenditure in 2007–2013.

factors. The deadlock in the Doha Development Agenda talks prompted the EU to make an additional gesture of abolishing trade-distorting subsidies, shifting most of the support to the »green box« within a framework of payments decoupled from production. Furthermore, Fischer Boel, the previous Agriculture and Rural Development Commissioner, pushed an ideological programme with a pro-free trade slant, which increasingly subordinated agricultural policy to the EU's trade policy, and with progressive elimination of market intervention.

In September 2012, the OECD published an update of its estimate of levels of support for agriculture, which registered an all-time low in the OECD taken as a whole, with a percentage in the European Union of 20 per cent of agricultural income for 2011, compared with an estimated 39 per cent in 1986–1988. The trend confirmed the notification that the EU had sent the WTO in April 2012, which indicated an all-time low in the total Aggregate Measurement of Support with trade-distorting effects, the so-called »amber box«. In the EU in 2009, they stood at levels of less than 50 per cent of estimated levels in 2006. The trend is set to continue over the next few years, if the programme of reforms proposed by the Commission for 2014–2020 is applied, given that most of the support will consist of payments disassociated from levels of production, either in the form of basic payments or in the form of a »green« payment of an environmental nature. The last financial report published by the Commission confirmed that intervention in the agricultural markets accounted for just 5 per cent of CAP expenditure.

Curiously, the CAP, which is eyed suspiciously abroad as the »enemy«, has been following the recommendations that the OECD has been making since the beginning of the 1990s on

how to implement transparent and more efficient systems of farm support. And, paradoxically, it is the United States – and its Farm Bill, which is expected to be approved in spring 2013 – that is moving away from the system of decoupled payments, increasingly returning to anti-cyclical approaches or support for income insurance programmes, rather than climate and market risks.

So far, the European strategy in the Doha talks does not appear to have had any other effect than to slow negotiations down. While the EU has been gaining leeway in the agricultural negotiations, decoupling payments marking a red line not to be crossed, developing countries do not appear to be willing to make concessions in manufacturing and services. A genuine novelty in 2012 was the signing of the banana agreement (8 November), which replaced a complex system of imports with a tariff system. This will pose a challenge to small-scale producers and growers in the European Union and to the developing countries in the ACP area. Moreover, the Commission continued to work on bilateral talks, which are a new element of pressure on the European agricultural model. In February 2012, the European Parliament ratified the revised association agreement with Morocco, which took effect in October. At the end of 2012, the agreements with Colombia and Peru, and with the Central American countries, were in the closing stages of parliamentary ratification. The talks with Mercosur are still going on, following the meeting of the Bi-regional Negotiations Committee held in Brazil in October.

Without doubt, trade is important to the development of the Spanish food and agriculture sector, which has been performing very positively abroad, with a cumulative positive balance of 4.322 billion euros between September 2011 and August 2012. Spain is interested in

opening up new emerging markets (in fact, Russia has been admitted into the WTO) that might value Mediterranean products. If that is to happen, investment in innovation and competitiveness is a priority, as it is also important to soften the pressures on the most vulnerable agricultural systems. That requires an intelligent design of the CAP assistance programmes post-2013, as well as transitional support mechanisms for farmers to help them adapt to the new market situation, as could be considered in a strengthened European Globalization Fund.

Additionally, and no less importantly, the EU has to meet challenges on a global scale, accepting the fact that decisions about the CAP not only affect our agriculture, but also the food needs and environment of the planet. In this respect, the EU must focus its attention on three areas over the coming years.

First is acknowledgement of the CAP's potential effects on developing countries within the framework of its Policy Coherence for Development commitments. We are still far from seeing the CAP as a policy geared towards development, but its reforms have an impact on many agricultural systems. Any trade agreement must provide for serious assessment of the impact on vulnerable systems, small-scale farming and the rural poor of the countries concerned.

Second is food security. Food availability and scarcity should not cause particular concern in European society, given that the problem of poverty does not currently stem from a limited production capacity, but from the inability of a growing number of families to access to jobs and income. The aim of Millennium Goal 1, to reduce the undernourished population of developing countries to 11.6 per cent by 2015, is unattainable, according to the estimates contained in the latest »State of Food Insecurity in the World« report (2012), published by the FAO,

the WFP and the IFAD. The production of cereals in the EU in 2012 (289 million tonnes) did not beat the record harvest of 2009 (315 million), but it topped the figures for 2007 (247 million) and 2008 (259 million). The European Union could commit to food security in the planet not only by providing food, but also, and especially, by offering innovation and research and by allocating resources to funding the development of small-scale agriculture in the poorest areas of the globe. Moreover, one problem is not just the level of production, but the way in which it is being reached. The Commission appears to have grasped that biofuel production based on crops can take land and resources away from the production of food and is therefore looking into the possibility of limiting the scheduled threshold of crop fuel-based energy consumed by the transport sector to 5 per cent by 2020 (it is currently 4.5 per cent). Clearly, it will require increased efforts to develop biomass technology based on non-agricultural raw materials if the threshold of 10 per cent of transport fuel from renewable energies is to be reached.

Lastly, a third area of interest is the sustainability of production and climate change mitigation. The CAP reform post-2013 will give greater priority to sustainable agriculture. It will be done at an additional cost to the EU farming sector, which, according to the estimates of the International Centre for Trade and Sustainable Development (ICTSD), will be in the region of 5 billion euros. For that to happen, a change of model with regard to the way that food is consumed and produced is required. Spain has major environmental assets, such as its agroclimatic diversity, its conditions for the production of olive oil, vineyards and fruit and vegetables, as well as the fact that it is the member state that devotes the largest area of land to organic production (1.8 million

hectares). The CAP post-2013 must be accompanied by national action addressed towards improving the technological capacity of the food and agriculture sector in order to form part of an agriculture that has less of an impact and

greater sustainability. In order to achieve that, it will be necessary to provide appropriate stimuli for the management of crops, water, soil conservation, biodiversity and public health, among other areas.

Energy in Europe in 2012. On the Threshold of a New Era

Pedro Moraleda

Change in the Energy Scene

Four concepts marked the world energy outlook in 2012, some of which had a particular impact on Europe.

- energy transition;
- shale gas;
- nuclear power after Fukushima;
- Arab Spring.

Energy Transition. The broad global consensus on the need to transform the current energy model was confirmed in December 2011 in Doha. This consensus is driven by environmental reasons, by the need to meet the irrepressible growth in worldwide energy demand in a sustainable manner and by a desire to better use finite energy resources such as hydrocarbons. Meanwhile, the countries hardest hit by the current economic and financial crisis are pinning their hopes of a return to economic growth and job creation on a new industrial revolution that includes a new energy model.

Shale Gas. We are witnessing the start of a revolution in hydrocarbons production, the so-called unconventional hydrocarbons, whose potential remains to be seen but which could substantially alter the geopolitics of energy in the immediate future.

Nuclear Power after Fukushima. While it might clash with the goals of increasing energy availability and reducing emissions, the viability of nuclear energy – one of the most important and cleanest sources of electricity generation – is under question following the accident at Fukushima, although perhaps not solely for that reason.

Arab Spring. An event of a different nature, but no less important, is the socio-political revolution that is spreading across the countries of North Africa and the Middle East. What is happening in this important hydrocarbons supply region raises serious concerns about their capacity to maintain exports, at least in the short and medium term. It is not easy to predict the impact of these events on energy supply but so

far they are having a negative effect on investor confidence and delaying projects, the consequences of which will be felt over the next few years.

The Impact on Europe of the Changing International Energy Context

A Geopolitical Context in Transition

In southern Europe, the so-called “Arab Spring” is taking place without significantly affecting energy supply. Traffic has not been interrupted through the main hydrocarbons transport routes or via the Suez Canal and the supply of oil and gas from Libya has been restored earlier than anticipated.

But whatever is the future development of this “Spring”, it has already given rise to events that impact the export potential of a good number of North African and Middle Eastern countries, due to:

- a sharp increase in domestic energy demand, based on a generous policy of subsidies;
- growing social demands that drain the domestic resources necessary for investment in hydrocarbons exploration and production;
- limited availability of external financial resources due to higher interest rates, in some cases because of greater country risk.

In eastern Europe, the question mark over the export potential from the Caspian Sea region also remains concerning the options for hydrocarbons transport towards Europe.

From the South East, while the sanctions imposed on the Iranian regime have barred this major oil exporter from supplying Europe since the second half of 2012, Iraq is poised to become one of the world's biggest oil and gas exporters.

Iraq has huge reserves and competitive production costs. The International Energy Agency (IEA) estimates that 50 per cent of the expected growth in world oil output over the next 25 years will come from Iraq and that its growth in gas production could rival that of Qatar. Iraq also has a clear advantage in terms of costs for supplying gas to the Balkan countries. Only internal disputes could damage its vast potential.

As for other traditional sources of supply, Russia acquired direct access to the European market without passing through Ukraine with the entry into operation of the two sections of the North Stream gas pipeline in 2012. Russia is also leading the race to supply central and southern Europe from the Caspian following the agreement signed in November with the interested parties to build the South Stream pipeline. This project is in direct competition with the Turkish–European Nabucco gas pipeline and represents a significant expansion of the means of gas supply to Europe, although it does not contribute to diversifying the sources of supply.

From the north, Norway remains a very reliable supplier and is looking into increasing the capacity of the electricity interconnections with the continent to get more out of its hydropower generation and to enlarge its energy offer. This is a very interesting option for Germany – to offset its nuclear power generation deficit – and for Denmark (to minimise the impact of the intermittent supply from its extensive wind power facilities).

The news in the Atlantic is the slowdown in the LNG (liquefied natural gas) market. On one hand, the United States is not requiring the large volume of LNG that was forecast; on the other, the European market does not need more gas than that committed through long-term contracts.

In the south Atlantic, Equatorial Guinea is emerging as a new LNG exporter and Angola will be in a position to do so as of 2013.

Fukushima or How to Replace Nuclear Energy

After Japan, Europe appears to have been the place most affected by the accident at the Fukushima Daiichi nuclear plant in March 2011.

The outcome of that accident has been the decision by several European governments to put an end to or gradually reduce their nuclear programmes. The German government has announced the closing down of nuclear power generation in 2022: in other words, getting rid of 22 GW of electricity generation capacity in 10 years' time! This decision raises important questions about costs, emissions and the impact on global demand for the energy alternative sources needed to replace nuclear generation.

In 2012, Japan took up around 30 per cent of the LNG shipments initially bound for Europe to replace lost nuclear generation. This diversion of LNG cargoes has not had a significant impact on availability or on the price of gas in Europe due to weak internal demand in the European market. What remains to be seen is the impact it will have if Japan keeps up its present demand for LNG in the medium term.

The accident at Fukushima raised public concerns about safety at nuclear power plants and effectively increased the cost of nuclear power on account of additional safety requirements. Both the huge investment and the time needed to build new nuclear power plants pose a difficult challenge to their future at a time when we are on the threshold of a revolution in renewable energies and non-conventional hydrocarbons.

Meanwhile, the experiences at Olkiluoto in Finland and Flamanville 3 in France bring up the

question of whether Europe is still the industrial society that it was 30 years ago, capable of carrying out this kind of project.

Unconventional Hydrocarbons: The End of the "Peak Oil" Myth?

Few conferences or speeches on energy in 2012 did not address the topic of unconventional oil and gas, particularly shale gas.

For the purposes of this chapter, we will just say that shale gas is obtained by fracturing rocks at great depth in appropriate geological structures.

While shale gas is the archetypical unconventional hydrocarbon, it is just one part of the large amount of hydrocarbons that have proved capable of being produced economically.

The huge potential of unconventional hydrocarbons was highlighted by the IEA in its *World Energy Outlook 2012* and even accepted recently by the Organization of the Petroleum Exporting Countries (OPEC). Unconventional hydrocarbons are considerably changing the energy landscape and challenging the widespread myth of "peak oil".

According to recent estimations, unconventional gas could account for half of the growth in total gas production over the next 25 years. Unconventional oil has not attracted as much media attention but production figures could also be fairly significant.

The reserves of unconventional hydrocarbons are more equally distributed throughout the world and, coincidentally, the United States and China – the planet's first- and second-biggest energy consumers – appear to have the largest reserves of shale gas.

The United States might even become the world's first oil producer in the next decade,

ahead of Saudi Arabia, according to the IEA. This would be an event whose consequences would be necessary to study not just from the point of view of the global oil supply and demand, but also in terms of geopolitical impact and the future competitiveness of the US economy.

While the production of unconventional hydrocarbons is a reality in the United States, the debate is whether it could be replicated in Europe, in regions where the appropriate geological structures exist.

Obstacles to developing the shale gas potential outside the United States could arise from the technology and investment required, from legal frameworks which are not so favourable and, not least, from the opposition of ecologists. In Europe, while incentives to reduce energy dependency and the energy bill are very strong, the costs of producing shale gas appear to vary, the ownership rules as regards the subsoil are not particularly motivating and its social acceptance is far from clear. It will be interesting to obtain reliable data on the first explorations in search of shale gas being conducted in Poland. It will also be interesting to see how Europe can make compatible the commitment to a low-carbon energy model with major investments in hydrocarbons.

There was also plenty of good news about conventional hydrocarbons in 2012. New reserves are being confirmed in the eastern Mediterranean and, particularly importantly, in Eastern Africa. There were also significant improvements in recovery rates from existing oil fields thanks to new exploration technologies. Many of the new discoveries will not be bound primarily for Europe, but they will contribute to easing the tensions that strong demand from the emerging economies in Asia might cause.

Any Prospect of a Fall in Energy Prices?

The price of a barrel of oil is the most immediate and influential international benchmark as regards energy prices. Despite its traditional volatility, the cost of a barrel has remained relatively stable and high over the past two years, averaging, for the first time in many years, \$100 in 2011 and \$110 in 2012.

While in 2011 this high price could be credited to the concerns aroused by the Arab Spring, it did not appear to be justified in 2012 against a backdrop of no apparent tensions between supply and demand. The high price of oil is hampering economic recovery in Europe but it is an incentive to reduce the hydrocarbons share in the European energy mix and reduce the cost gap between conventional and renewable energy sources.

The potential of hydrocarbon resources, recent discoveries and technology improvements lead to the conclusion that energy will not be scarce. But exploration and production costs have increased considerably and the alternatives to conventional fuels remain expensive. The odds are that there will be sufficient but expensive energy in the medium to long term.

Gas prices have traditionally been tied to oil prices in Europe and Japan, although with different indexation formulas, and it was thought that they would evolve in parallel in the two markets. However, the wide availability of gas in the West and the huge need in Japan in 2012 gave rise to an extraordinary divergence in import prices. While the European LNG spot price remained three times higher than the price in the United States (Henry Hub), the price in Japan was twice that of Europe and six times higher than the price of gas in the United States. The debate on the price of gas in 2012, therefore, focused on explaining those divergences

and on its eventual disassociation from the price of oil.

The price of coal, a widely available and distributed fuel, fell in the United States and, as a result, consumption went up in Europe for electricity generation at the expense of natural gas.

The costs of producing renewable energies, an alternative for the future, have fallen dramatically, although they still cannot compete with conventional energies in Europe.

Energy prices for final consumers in Europe maintain the upward trend of recent years in the 27 EU member states. Prices of transport fuels increased above the CPI due to their direct link to the price of crude oil. Electricity prices rose moderately above the CPI.

An Energy Industry and Market in Europe in Full Swing

Other than the global energy challenges, the European energy sector is undergoing other tests.

Europe is close to concluding the transition initiated more than a decade ago towards a single energy market but, even before this objective is achieved, the European political leaders have already undertaken another commitment: a sustainable energy future.

As the target date of 2014 for achieving the internal market draws near, some uncertainties remain with regard to such a complex and ambitious process. One of those uncertainties is the viability of and alternatives to long-term supply contracts, which affect both European importers and exporting countries. Long-term contracts have been the cornerstone of the successful development of the gas and electricity industries in Europe and a condition for joint projects with external producers. European op-

erators have gradually adapted to the new context but some producers are wondering what guarantees they now have to undertake new projects to supply Europe.

The European Union's commitment to a sustainable energy future is clearly set out, in the Europe 2020 Agenda (20 per cent reduction in carbon emissions, 20 per cent renewable energies in the primary energy mix and 20 per cent improvement in energy efficiency) and in the Communication "Energy Roadmap 2050", which proposes a radical reduction in polluting emissions by reducing the hydrocarbons quota in the energy mix.

Recent events, however, appear to contradict this political will. In 2012, for example, the use of coal for electricity generation, instead of less polluting energy sources, such as natural gas, increased by an average of 10 per cent; the price of carbon dioxide (CO₂) emissions certificates dropped below \$10 per tonne, when it was supposed to be around \$40; carbon capture and storage (CCS) projects are held back due to technology, profitability (they require a price of \$100 per tonne of CO₂), social acceptance because of possible deepwater contamination and financial constraints brought about by the reduction in subsidies.

In addition to the change in market structures and strong policy commitment to efficiency and renewable energy, another cause of concern for external suppliers is the prospects of the European energy market, which has stagnated in recent years.

Following a very slight upturn in demand in 2009 and 2010, in 2012 the negative impact of the financial crisis kicked in. There are no signs of a swift economic recovery in the European Union and energy consumption is slowing down at a more rapid pace than GDP. This is a trend that may continue into the longer term in view

of the decrease in energy intensity and the new regulations aimed at increasing energy saving (Energy Efficiency Directive).

Forecasts indicate that the non-OECD countries will attract more than half of the additional energy supply over the next 25 years and that the centre of gravity of the energy market is shifting towards Asia and Africa.

Main Energy Initiatives in the European Union in 2012

In line with the policy put forward in the Communication of November 2010, "Energy 2020 – A Strategy for Competitive, Sustainable and Secure Energy", the European Commission maintained the priorities of energy efficiency, a single internal market, consumer protection, technology and innovation and the external dimension.

The Commission emphasised three of these priorities in 2012: going beyond the 2020 Agenda goals after 2020, defining the legal framework on energy efficiency and carrying out close monitoring of the process towards the single market. These priorities were embodied in the following documents.

"Energy Roadmap 2050" – Roadmap for Moving to a Low-carbon Economy in 2050

This is a Commission Communication published in December 2011 to provide member states, citizens, institutions and industry with topics for debate on ways of ensuring the goals of security of supply, sustainable development and competitiveness.

The Communication sought to build on the 2020 Agenda initiatives and proposed trans-

forming the energy system before 2050 by means of a substantial improvement in energy efficiency and a major increase in the share of renewable energy.

According to the different scenarios put forward in the document, by 2050 it would be possible: to reduce greenhouse gas emissions by between 80 and 95 per cent; to ensure that two-thirds of the energy consumed in Europe comes from renewable sources; and that almost all the electricity generation in Europe is produced without generating greenhouse emissions.

This Communication, which is very relevant for the debate on the future of energy in Europe, cannot prevent further doubts among external suppliers about the appeal of the European energy market in the long term.

Communication "Renewable Energy: A Major Player in the European Energy Market"

Published on 6 June 2012, it presented an analysis and put forward plans to reduce uncertainties related to renewable energy investment beyond 2020, the target year of the 2020 Agenda.

It calls for coordination of the various national schemes to support renewable energies and for facilitating the trade of these energies among member states.

The Communication also mentioned the importance of a Mediterranean Energy Community initially focused on electricity and renewables.

Energy Efficiency Directive (2012/27/EU)

Published on 25 October, it was the most important legislative initiative of the year.

It is a directive of minimum requirements, very ambitious and complete, that: “establishes a common framework of measures for the promotion of energy efficiency within the Union in order to ensure the achievement of the Union’s 2020 20 per cent headline target on energy efficiency and to pave the way for further energy efficiency improvement beyond that date ... and provides for the establishment of indicative national energy efficiency targets for 2020” (Article 1).

The explanatory preamble states, among other things, that energy efficiency is a powerful tool to fight the economic crisis. Undoubtedly, energy efficiency is the most important source of energy and investment in energy efficiency programmes is the most profitable one. The question, however, is to what extent the current economic crisis would allow to take the decisions necessary to implement the Directive.

***“Making the Internal Energy Market Work”:
Communication on the Status of the Internal
Energy Market of 15 November***

This is an extensive and detailed Communication that highlights the advantages of a single internal gas and electricity market and lists the progress made, but also warns that the EU is not on track to meet the 2014 deadline. It points out that the internal market is not an objective in itself, but a means of delivering economic growth and a requirement for the transition towards a low-carbon economy.

The Communication summed up the analysis of the situation in six concise messages:

- a process of reaching renewables and energy efficiency targets;
- a slight fall in the degree of energy dependence;

- increased competition among gas suppliers;
- improved liquidity and integration of electricity markets;
- progress on competition in general, but low rates of switching suppliers;
- rising consumer prices and little convergence among prices in different states.

The Communication included a precise Action Plan to be revised annually with measures aimed at obliging compliance with the regulations, improving consumer information and protection, preparing the energy transition and ensuring adequate and coordinated intervention on the part of the member states.

Last Energy Ministers Council of the Year

The gathering took place on 3 December and focused on the regulatory framework for renewable energies beyond 2020. It reaffirmed the priorities of an open and competitive internal market, improved integration of renewable energies, promotion of cooperation and exchange, development of infrastructures, consumer attention and the commitment to technology, innovation and sustainable development.

***Joint Communication of 17 December on
“Supporting Closer Cooperation and Regional
Integration in the Maghreb: Algeria, Libya,
Mauritania, Morocco and Tunisia”***

This Communication, an initiative of the High Representative of the Union for Foreign Affairs and Security Policy, states the European Union’s great interest in the success of the modernisation and democratisation processes that are taking place in these countries, highlighting the importance of the greater integration of the

Maghreb for its economic development. The Communication proposes a major debate among all the interested parties and lists the ways in which the EU might contribute to that greater integration. In order to encourage the debate, it announces a high-level summit with the Arab Maghreb Union in 2013 and support for specific technical projects.

Some Relevant Figures

The latest official statistics from 2010, published by the European Commission in "EU energy in figures – Statistical Pocket Book 2012".

- **Primary energy:** Total consumption of 1.759 billion tonnes of oil equivalent (toe) in the European Union (27 member states).

By energy source: 35 per cent oil products, 25 per cent natural gas, 16 per cent coal, 13 per cent nuclear and 10 per cent renewable energies.

- **Origin of raw materials:** Europe imported just above half of its primary energy needs (54 per cent). Imports of oil and its derivatives accounted for 84 per cent of total consumption, gas accounted for 62 per cent and coal, for 40 per cent.

The European Union's main energy partner is Russia, source of 34 per cent of oil, 35 per cent of gas and 27 per cent of coal.

Other major providers of oil are Norway (14 per cent) and Libya (10 per cent). The main providers of natural gas are Norway (27 per cent) and Algeria (13 per cent). There is larger diversification in the sources of supply for coal: Colombia (20 per cent), the United States (17 per cent), Australia (11 per cent) and South Africa (10 per cent).

- **Final destination or consumption of energy:** transport (32 per cent), industry (25 per

cent), homes (27 per cent), shops and services (12 per cent), agriculture (2 per cent).

- **Electricity capacity installed:** 904 GW. Generation technologies installed: fossil energies (coal, gas and oil) 54 per cent; hydropower, 17 per cent; nuclear, 15 per cent; wind, 8 per cent.

Total electricity generation: 3,346 TWh (303 TWh in Spain). Energy used for electricity generation: nuclear, 27 per cent; coal, 25 per cent; natural gas, 24 per cent; renewable energy, 21 per cent. Among the renewable energies, hydropower provided 57 per cent of the total and wind power, 21 per cent.

- **Consumption per capita:** 3,507 kilograms of oil equivalent (koe); of electricity: 5,652 kWh.

Conclusion

Many of the changes taking place in the energy world pose a tremendous challenge to Europe.

The energy industry is no longer a driving force in Europe for economic development. Besides, Europe is located between two economic blocs that are increasingly integrated and have clear competitive advantages: in the east there are countries where development is in full swing, such as China, with lower labour costs and the strength of a "sole purchaser" of energy for a billion inhabitants; in the west is America, a Continent that is on the way to having cheap and abundant energy to satisfy its own needs.

To meet the geopolitical challenge, the European Union needs to proceed rapidly with its market integration, to enlarge its economic space and to keep the lead in new energy technologies.

The **single European market** is a priority of the Union and a stronger commitment on the

part of the member states is still required to lift the legal and physical barriers that are restricting energy trading. A single market and a coordinated policy might position Europe again as a market of reference.

Closer integration with the countries to the south and east of the Mediterranean – a Mediterranean energy community – is also on the agenda of the European Union. Southern and Eastern countries have a combined population of 280 million inhabitants that could reach 350 million by 2030, an estimated GDP growth of around 4 per cent per year over the next 20 years, energy demand with a similar growth rate, greater potential to generate renewable energies than Europe and enough hydrocarbons reserves to ensure the transition towards a sustainable future.

A large Euro-Mediterranean energy market would provide additional economies of scale and would make it possible to benefit from the considerable synergy among the countries of the Mediterranean Basin. In order to achieve this a different cooperation model is required, a model focused towards the integrated development of the region. Up to now, oil and gas exports have generated income but not economic development in the South. There is a pressing need for a legal and institutional framework that facilitates cooperation on joint and long-term projects. Moving beyond a simple buyer–seller contractual relationship by means of shared projects would also compensate for the guarantees traditionally provided to investors by long-term contracts.

Leadership in renewable energies, and energy efficiency is another alternative. If the present energy model is showing signs of exhaustion, leading the energy transition would create new business and job opportunities. Europe's competitive position in terms of renewable

technologies is a good springboard for managing the energy transition. The German initiative towards a very low-carbon economy, even without nuclear energy, can be a stimulus and an example worth studying.

The fact is that the technological know-how to make the leap forward in energy efficiency and in renewable energies is already available. We already know what the most effective measures for improving efficiency are and the markets in which these measures would be most effective. Even in the transport sector, major savings can be made without having to wait for a huge technological leap. As for renewable energies, investment costs have dropped sharply over the past five years and there are sites where they manage to generate solar power for less than 20 euro cents per kilowatt hour, with kilowatt hours of wind power costing even less.

But the market alone is not taking us in this direction because energy transition is not the industry's first choice in a highly competitive market and at a time of deep economic crisis. Clear political leadership is required, a boost from the competent authorities to complement private initiative, with the goals of:

- Implementing the energy efficiency regulations and ensuring their accomplishment; in Europe, it would be a matter of transposing the relevant directive to national legislations and developing the appropriate regulations.
- Allowing renewable energy to compete on equal terms with well established energy generation means, offering the same guarantees that were offered for investment in hydropower, nuclear or gas projects in their day.
- Internalising the external costs of energy use by means of maximum emissions quotas or raising the cost of CO₂ emissions so that more economical alternative energies in the

short term do not relegate the environmental goals.

- Paying for the reserve capacities required to compensate for the intermittence of renewable energies during the transition phase.

Public intervention is justified because Europe cannot continue to increase its level of energy dependency. The cost of this dependency

is a gas and oil import bill that amounted to 500 billion euros in 2011.

It is no less justified by the fact that climate change has been described as the most serious and widespread market failure the world has ever seen (Stern Review on Economics of Climate Change 2006).

2012: A Year of Environmental Constraints and the Collapse of the Carbon Market

Teresa Ribera

The year 2012 was not a good one for the environment in the European Union. Like many other pillars of the European construct, environmental and climate policy were shaken, once again, as a result of the economic turmoil. The fear of shifting forward in environmental issues turned 2012 into a year of resistance, in which the greatest achievement was to maintain the level of commitment achieved so far.

The year ended with no significant progress on any of the key environmental issues. This is the case both within the EU and abroad, despite the fact that three major international conferences were held. Neither the Rio+20 Summit, the Conference of the Parties to the Convention on Biological Diversity nor the recently ended Conference of the Parties to the United Nations Framework Convention on Climate Change (UNFCCC) made any significant breakthroughs in environmental policy.

With the notable exception of the agreement reached with Australia in August to create

the first inter-continental linking of emissions trading systems in the near future, global meetings have resulted in few tangible results. The agreement to develop alternative indicators beyond GDP (Rio) or reducing to a single negotiation channel the different open processes under the UNFCCC were among the most noteworthy. Taking the outcome of all the meetings together, it can be said that they avoided rupturing the international consensus on these matters and held fast against any reversal of agreements already made. In terms of strictly European initiatives, the only area to see a tentative improvement is the development of tools for the management and protection of our fresh- and saltwater ecosystems, although this could be said to be the result of earlier actions now bearing fruit rather than the breaking of new ground.

It is a worrying picture. For the past twenty years, the EU has been casting itself as the body of regional integration, as a global political play-

er promoting policies that defend social well-being and equitable access to resources. We thought we understood the impact of environmental protection and regulation on equality of opportunities and, because of this, the importance of ensuring a correct allocation of costs for environmental degradation and boosting measures that safeguard the common enjoyment of environmental assets. These policy goals have been painstakingly built up through protecting the environment and integrating sustainability into other policy areas, including foreign policy, industry, energy and the economy. Europe is now suffering an identity crisis despite its desire to improve its citizens' quality of life, reinforce equity and social well-being and consolidate itself as a global player in building a peaceful, fairer and more equitable future. This explains the devastating paralysis in the political will regarding common environmental policy and the difficulties in moving forward with respect to the climate crisis.

The cracks appearing in the environmental policy agenda are paradoxical at a time when, in order to overcome the crisis, Europe needs to identify areas of growth that will strengthen the European project. Environmental protection and the energy switch to clean technologies and smart energy consumption are two highly attractive areas for immediate investment. Not only would they support growth policies, but they would serve to strengthen the political and economic reputation of the EU in the medium to long term. A committed approach to this line of thinking throughout 2012 would have helped stall economic decline and unemployment in Europe, boosting innovation and industrial activity and helping Europe to recover its purpose as a political heavyweight. It might have been the right time to refocus Europe's soft power towards peaceful relations between nations and

improved quality of life for its citizens. Instead, we looked on in stunned silence as these tenets were undermined and now face a situation that is likely to slow down domestic recovery and damage Europe's credibility as an international political and economic player.

Climate Action

In early 2012 (30 January), the Commission published a proposal to achieve a 25 per cent domestic reduction scenario by 2020, authorising up to a 5 per cent additional reduction to be met through international emission reduction credits. A subsequent analysis of the potential for greenhouse gas (GHG) reductions by land use, land-use change and the forestry sector was promised. The Commission stated, moreover, that a fall in the price of CO₂ could lead to the paradoxical situation of a European lock-in to fossil fuel technology, delaying and adding to the cost of the industrial and energy transformation. Europe could lose its competitive edge. Indeed, the Commission was at pains to warn against the mistaken – and economically dangerous – policy of postponing decarbonisation until the economy had recovered along traditional lines. The proposal provided an analysis based on the costs and benefits of the package, both direct and indirect; the sectors and amounts requiring additional investment; potential emission auctioning revenues to ease the transition; and instruments that could be used to increase the level of ambition simply and effectively. It was accompanied by estimations of costs and savings country by country.

The Environment Council Meeting in March ended in stalemate. That is to say, nothing was achieved. The lack of response from the Council had the immediate effect of further undermin-

ing the CO₂ price signal offered by the European Emission Trading Scheme, the cornerstone of the EU strategy to combat climate change.

Since then, an intensive debate has raged on whether or not further regulation of the CO₂ market is needed. The main arguments in favour concern reinstalling price signals and revising emission reduction allocation time profiles to better exploit the margins offered by the lower industrial activity and energy consumption reported during the years of crisis.

The arguments against argue that the intention of the CO₂ trading schemes was to establish a CO₂ reduction mechanism at the lowest possible price and that this objective, for the time being, has been met.

Finally, with industry and governments divided; in view of the evident risk of breakdown in the domestic market resulting from the adoption of increasingly unilateral measures by some countries, notably the most ambitious, the Commission published its report on "The state of the European carbon market in 2012" on 14 November. The report was complemented by a draft amendment to Commission Regulation 1031/2010 on the volume of greenhouse gas emissions to be auctioned each year. The report on the state of the European carbon market recognises that there is an over-supply of allowances as a result of the economic crisis and that the entry of international credits into the European market has been more generous than anticipated.

The magnitude of the surplus, unless corrected, could have long-term repercussions beyond 2020, making it practically impossible to stimulate emission reduction in the future. The Commission outlined six possible structural measures to be pursued if measures to postpone the auctioning of emissions trading were adopted swiftly, including the creation of a cen-

tral mechanism to safeguard the optimum liquidity of the market at any given time. The report assesses the impact of the different options, including the consequences of taking no action. Finally, the proposal was made together with the surprising announcement that the Commission was rethinking legislation on aviation emissions and was to stop the clock on enforcement until after the ICAO reached agreement at its next General Assembly. De facto, this measure means excluding EU and third party aviation from European regulation, as had been requested by the USA and China.

The good news is that this "November package" is a clear signal that the Commission is concerned about current levels of apathy in the European market and that there is the will to improve a key pillar in EU policy on climate change. The bad news is that the announcement has had no impact on the market, nor has led to any signs that would make us think that operators have recovered faith in the ability of Europe's institutions and governments to deliver a coherent and committed solution that will guarantee their leadership in climate action. Not only did the announcement not lead to an increase in the price of CO₂ but it was, in fact, followed by a drop. Analysts are cautious, stating that while the options themselves are reasonable, their presentation is inadequate. With respect to the aviation announcement, it met with a wide variety of reactions, but what no one has forgotten is that community regulation was adopted following 15 years of inaction by the ICAO and following 10 years of unilateral effort by the EU. Now we find that vetoes from other countries are hindering the approval of a global response:

- The main obstacle to keeping a reasonable CO₂ price signal is not a technical one. The options short-listed by the Commission are

sound, although many questions still need to be developed. The right combination of options would be enormously beneficial for the trading system, allowing a degree of flexibility in managing optimal liquidity, in reviewing quantity limits of international credits entering the European market and, in the short-term – it is hoped – the quantity of credits leaving Europe towards a third party market or region.

- There seems to be a growing trend among stakeholders (national or European public sectors, the industrial sector) calling for the EU to reduce its level of ambition until other powers adopt similar measures. Their concern is legitimate: being the first to assume the extra burden is feasible for a time, but cannot be sustained indefinitely. However, the way in which this concern is being expressed and managed is generally aimed at actively suppressing the mechanisms and targets for emission reduction beyond the effect of inertia. Would it not be more efficient and positive for the EU to channel its available instruments and exert the necessary pressure to increase the level of ambition of other countries instead?
- The undermining of the current framework by highlighting doubts and divisions between member states and lack of coherence – for example, backtracking on airline emissions – does little to strengthen the EU's credibility and threatens the ultimate success of the process. Nor does it enhance the competitiveness of Europe's industry in the medium to long term. Moreover, a badly-handled attempt to offer a choice between all or nothing is, given the present levels of breakdown, a high-risk and ill-advised operation.
- The carbon price signal is designed to accelerate the shift towards a low-carbon econo-

my. This signal can either be a tax or a CO₂ market. We cannot allow the parties that backed the carbon market in order to avoid the tax to now reject measures that will allow the system to function as intended. The possible outcomes following the breakdown of the emissions trading scheme are two-fold: the fragmentation of the domestic market resulting from the growing adoption of unilateral measures by member states or the adoption of a common tax in the short term. Of the two, one would have to agree that the latter would be the more attractive option in the event that the adoption of measures to strengthen the market prove impossible.

The EU returned from Doha with a sense of satisfaction: international climate negotiations were successfully streamlined from parallel working groups into a sole negotiating forum; the Kyoto Protocol was kept alive at a time of transition; modest steps towards finding instruments that will address the loss and damage associated with climate change in developing countries were taken; an important step for the continuity of the Clean Development Mechanism was made; and there was a commitment to continue studying multiple channels for the creation of new global market tools.

On a theoretical rather than a practical note, but interesting nonetheless, ways were outlined to achieve more ambitious national emission reductions by 2020 and, more importantly, there was a sustained commitment to reaching a global climate agreement by 2015. Despite this, 2012 did not deliver a coherent response to the need to hold global warming below 2 degrees of temperature rise over the average levels of the pre-industrial era and there were urgent calls by the scientific community for action in the Arctic and Antarctic zones.

For this, we shall have to wait until 2013 and the expected Green Paper on 2030 targets in which the Commission is to put forward its proposals for energy and climate targets to 2030 in line with the 2050 decarbonisation and the 2011–2012 transport roadmaps.

Environmental Policies

In terms of environmental policy, the most important objective of the European Commission for 2012 was working towards smart implementation. Sustainable consumption and production, green public procurement and an effective implementation of waste management were some of the key proposals. In general, environmental action was made a priority objective to be attained if the EU 2020 Strategy is to be fulfilled. Hence the Roadmap to a resource efficient Europe, in a world in which there is increasing pressure on resources, has a key role to play in the design and implementation of future actions.

The year 2012 was certainly a period of reflection and debate on how to get more out of environmental policy. Among the tangible results of this phase was the 7th Environmental Action Programme debated by the EU Environmental Council in December and the proposal for an action plan for safeguarding Europe's water resources, known as the "Water Blueprint". Then there was the agenda proposed by the Biodiversity Strategy adopted in 2011 and the mantle of guardian of the environment taken on by the EU at the Earth Summit in Rio de Janeiro in June 2012. The clear message given out by the EU environmental policymakers was that the implementation of environmental legislation also represented an opportunity for job creation. However, the lack of resources at na-

tional level, aggravated by the bitter debate on the financial prospects of the EU budget and austerity, meant that these comments were received with scepticism both by the general public and by institutional leaders at different levels of government.

One of the most important tangible results from 2012 was the final approval of Directive 2012/19/EU on waste electrical and electronic equipment (WEEE) following several years of groundwork by the Commission and the Council and intensive debates in the European Parliament seeking to find consensus between institutions. The Directive revises and recasts environmental legislation in this area.

Given the very high rate of replacement of this type of equipment, the volume of waste generated is significant and increasing. Moreover, this waste includes substances that may damage the environment and needs to be disposed of safely. They are also a valuable and potentially reusable resource in the same sector. The Directive seeks to strengthen vigilance regimes and eradicate bad practices that are hazardous to third parties and shameful for all, such as the illegal export of e-scrap from the EU to unregulated dumps in developing countries.

The question of how best to enforce environmental regulations and the mainstreaming of "resource efficiency" into other policy areas fell foul of budgetary discussions and debates. Held back by member states cutting back on contributions to the common purse, discussions on the basic problem of how to ensure coherence of environmental policy issues with agriculture, fishing, transport and trans-European networks or how to strengthen European energy policy, have been put on hold for the time being. Nevertheless, we should welcome the fact that this debate has been left open and that environmental tax reforms and cutting of subsidi-

dies to environmentally damaging activities are still on the agenda.

As already mentioned, the two most interesting proposals presented by the Commission in 2012 are the Water Blueprint for safeguarding Europe's water resources and the 7th Environmental Action Programme. Neither contemplates specific legislative measures but are designed to guide sectoral policy and financial and environmental actions over the next few years by bringing to the attention of all, once more, Europe's precious and limited resources and the critical role they play in safeguarding human well-being and economic activity.

On 15 November 2012, the Commission tabled the first of its proposals. Its Communication set out a diagnostic of the main threats to Europe's vast and varied land and maritime water resources – including climate change and over-use – emphasising their impact on the environment and the economy. The proposals included tools and indicators to help assess the state of our waters; improve water management and protection; and boost specific measures relating to water conservation. To address this, considerable effort has been put into incorporating powerful multiannual financial tools envisaged in “green infrastructure”, which should be fully integrated into other policy areas, as well as Structural and Cohesion funds.

Following the final assessment of the 6th Environmental Action Programme, the Environment Commissioner and Climate Action Commissioner proposed a 7th successor programme to guide the Council debate in December. In contrast to previous programmes, the Commissioners prepared a short but comprehensive reflection designed to achieve coherence between policy planning and the roadmaps approved in recent months. The proposal identifies nine priority objectives, including protecting natural

capital and increasing ecosystem resilience; boosting sustainable low-carbon growth and resource efficiency; and tackling potential environmental risks to human health.

It could be said that we are in the midst of an adolescent crisis in which environmental policies – whether well or badly implemented – have moved beyond being simply action to becoming a key component of the EU's concrete and strategic focus. With increasing numbers of stakeholders posing problems for coordination quality and efficiency; the widely recognised need to change our growth model and economic and industrial policy; and Europe's position in an increasingly complex and wealthier world, our continent is having to question many of the assumptions on which the development and growth of European society is based.

But a mere conviction of living through a transitional stage cannot excuse complacency or delays, nor indeed, does it guarantee a successful outcome. The EU may emerge victorious from this complex transformation, asserting its multiple strengths in resource management and know-how or, conversely, we could see an escalation of environmental, economic and social burdens that could lead us to breaking point. The outcome will depend largely on us getting it right and whether there is the political will to recover a common future in which limited resources and equitable access are integrated into European policy and decision-making.

Still on the drawing board are the potential progress in international environmental governance- including the frustrated attempt to transform the UN Environment Programme (UNEP) into a truly international organisation; the identifying of tools to protect global biodiversity; and the adoption of instruments and criteria to ensure access to financial resources that protect biodiversity. Little tangible progress was made in

these areas in 2012 beyond the satisfaction of knowing we have avoided losing ground on the open processes running their course in the Unit-

ed Nations. But, as we all know, lack of action is not neutral in effect and makes it increasingly difficult to hold one's ground.

The Common Foreign Security and Defence Policy

The External Action of the EU in 2012: Progress on Instruments (EEAS), Political Slowdown

Francisco Aldecoa, Vicente Palacio

Introduction

Annual State of the Union addresses delivered by European Commission (EC) presidents serve as barometers of Europe's priorities and preoccupations at a given moment in time. If one examines the details of the State of the Union address delivered by current EC President Manuel Durao Barroso on 12 September 2012, one quickly becomes aware that the greater part of it dwells on matters pertaining to economic governance (fiscal union and banking union) and democratic accountability. The small portion of the address devoted to Europe's external projection and its role as a global actor consisted of a few short phrases expressing pride in Europe's role as a beacon of values, praise for humanitarian assistance, preoccupation concerning the conflict in Syria and the need to strengthen Europe's military capacities. Such scant reflection on foreign policy and security is symptomatic of the fact that enormous energy

is being focused on the challenges of integration in a Europe reeling from the economic, political and social effects of the sovereign debt crisis. One rapid consequence of this crisis has been a loss of momentum in the implementation of policies designed to further the EU's external projection: a political slowdown that has diminished the Union's capacity for action, its image in the world and, consequently, its legitimacy as a player in world affairs.

Nevertheless, the overall outcome for the period extending from the end of 2011 to the beginning of 2013 can be considered moderately positive in this area. This is because the fundamental instruments needed to pursue external action initiatives and the institutional mechanisms to implement them were put on a strong footing during this time. The most notable of these instruments is the European External Action Service (EEAS), which since its launch in 2010 has rapidly become one of the EU's most important vehicles for conducting diplo-

macy. It is nevertheless clear that in order to fully exploit the potential of this instrument in the near future, the Union must resolve its internal problems to the extent that the rest of world perceives that it has overcome the challenges of the crisis and entered a new virtuous cycle.

Coping with these internal problems has meant that much more progress has been made on the development of policy instruments than on policymaking itself. As the EEAS is an especially noteworthy example of this progress, this report focuses strongly on its development during 2012. However, the European institutions implicated in the formulation, implementation and oversight of external action (the Council, High Representative, Commission and Parliament) also merit attention, as they have accounted for much of this year's activity. If the EEAS has not met every challenge successfully its first time out of the gate, at least it has gained valuable experience and has promoted debate and the routine oversight of European foreign policy.

Another bit of good news is that no significant rifts have occurred that might have thrown the slow development of Europe's external projection off track. On the contrary, it has enjoyed a period of stable continuity. Rather than bouts of confrontation, there have been moments of *active intergovernmentalism* (one example being the Libyan crisis, in which French and British interests came into play and Germany refrained from taking a military role) and moments of *passive multilateralism* on the part of principal member states, which took the form of lack of momentum, dispersion of interests or tacit dissent on issues involving Latin America, China, the status of the Palestine Territories and Libya.

As our analysis focuses on instruments and institutions, this chapter will provide a general overview of the external action policies related

to the area most affected by the crisis – Europe's role as a major player in world events – which are those related to specific geographic areas, multilateral organisations, human rights and the enlargement of the Union itself. Other chapters of this report provide more detailed information and analysis regarding policies that address specific geographic areas such as the regions along the EU's eastern and southern Mediterranean borders, strategic partnerships, the Common European Security and Defence Policy (CESDP) and specific areas and sectors such as agriculture, the environment and energy.

Instruments for External Action

Developments since the Treaty of Lisbon

It should be remembered that the 2007 Lisbon Treaty revived the structures of the Common Foreign and Security Policy (CFSP) established in the draft Constitutional Treaty and laid out the new Common Security and Defence Policy (CSDP). It also incorporated other important elements drawn from the European Convention, such as the position of Minister (now High Representative) of Foreign Affairs and Security Policy, which provides leadership for the EEAS.

The Lisbon Treaty defines the position of the High Representative (HR) in the very same terms used to define the position of Foreign Minister in the draft European Constitution; nothing has changed other than the title. The present position is structured much more along the lines of those held by the foreign affairs ministers of EU member states than that of the earlier post of High Representative for the CFSP and encompasses many more tasks. Under Article 18 of the treaty, the High Representative serves as chief of the CFSP, but Section 3 stipulates that the HR

shall also preside over the Foreign Affairs Council (a function formerly carried out on a rotating basis by ministers of state). Furthermore, Section 4 establishes that the HR shall be one of the vice-presidents of the Commission and shall be responsible for the coherence of the EU's external actions.

Article 27.3 states that the EEAS shall assist the High Representation in the exercise of his or her mandate. This service has now begun to work in collaboration with the diplomatic services of member states and comprises officials from relevant departments of the General Secretariat of the Council and the Commission, as well as staff seconded from the national diplomatic corps of EU member states. This entire structure has been made operational in the three short years since the Lisbon Treaty entered into force on 1 December 2009 and Catherine Ashton was appointed HR.

Throughout this period, the EEAS has steadily evolved into the institutional branch responsible for carrying out the EU's foreign policy. One of the characteristics that has demonstrated the EEAS's fulfilment of this role is its contribution to the consolidation of regulatory power, which in this context can be understood as the EU's ability to play a role in establishing the regulations that form the basis of international relations and the rules of the game by which all international players act and that determine the political, economic and social opportunities that may open up for them and advantages they may gain in the future within the international system. The EEAS is now bringing a new unity and coherence to the way in which the European Union exercises its regulatory power.

The Council issued the decision that established the organisation and functioning of the EEAS on 26 July 2012. According to Article 1.2 of the decision, the EEAS shall be "a function-

ally autonomous body of the European Union, separate from the General Secretariat of the Council and from the Commission with the legal capacity necessary to perform its tasks and attain its objectives". Article 2 states that the EEAS "will support the High Representative in fulfilling his or her mandates", and makes special reference to three of these: to conduct the CFSP, including the CSDP; to serve as President of the FAC; and to serve as Vice-President of the Commission. As such, the roles of the HR and the EEAS are purposefully entwined, although each has its own characteristics and duties. Article 3 establishes that the EEAS shall function under the authority of the HR and be structured around a central administration and delegations that shall represent the Union in third countries and international organisations.

The reforms laid out in the Lisbon Treaty in the area of foreign policy have considerable scope and significance; in one fell swoop, they created a Ministry of Foreign Affairs, the position of High Representative, a Minister and Ministry of External Affairs, embassies and delegations of the EU and invested them with all the characteristic functions of traditional diplomacy.

Structure and Operations during 2012

During the second year of its operations, the EEAS continued to incorporate personnel, frequently looking to the Council and, especially, the Commission, as a source of trained personnel to fill positions. It is also slowly incorporating diplomats from member countries, who filled the higher positions of the organisation throughout 2012. This was a year of solid consolidation and deployment in the area of human resources and only a few positions are pending recruitment. Under Article 13.3, a review of the

organisation will be undertaken by mid-2013 and modifications may be introduced in 2014 based on this assessment.

At present, the EEAS has a staff of 4,000, slightly less than half of whom work at the Brussels central office. The rest serve as members of EU delegations or staff in EU embassies around the world. The two new delegations sent to Libya and the Southern Sudan in 2012 brought the total number of delegations to 140. There is also an office in Myanmar (Burma) that will soon be raised to the status of delegation.

The EEAS's central administration is structured much like that of comparable ministries maintained by member states. As of 2012, this included an Executive Secretary General (Pierre Vimont of France), a Chief Operating Officer (David O'Sullivan of Ireland) and two Deputy Secretary Generals: one for Political Affairs (Helga Schmid of Germany) and the other for Inter-institutional Affairs (Maciej Popowski of Poland).

The EEAS has seven directorates general, two of which are operational and five of which cover geographic areas that include Asia, headed by Viorel Isticioaia Budura of Romania; Africa, headed by Nicholas Westcott of Great Britain; the Middle East and southern neighbour states, headed by Hugues Mingarelli of France; and the Americas, headed by Christian Leffler of Sweden. This year, Luis Felipe Fernández de la Peña, the former Spanish ambassador to the Russian Federation, was appointed to the position of Managing Director for Europe and Central Asia, a landmark decision that brought appointments into a geographic equilibrium, given that prior to this nomination, Spain was the only one of the EU's five largest states that had not been called upon to provide a managing director for an EEAS directorate.

The operational directorates general are the Directorate for Global and Multilateral Issues, headed by Maria Marinaki of Greece, and the Directorate for Crisis Response and Operational Coordination, headed by Agostini Miozzo of Italy. The latter is responsible not only for the CFSP and the CSDP, but also for the PCSD, which underwent a process of revitalisation during 2012.

Article 6.6 of Council Decision 2010/427/EU states that recruitment to the EASS shall be based on merit, while ensuring adequate geographical and gender balance. Furthermore, Article 6.9 of the same document establishes that "when the EEAS has reached its full capacity (...) staff members from member states should represent at least one third of all EEAS staff at the AD level". Great strides were made towards this objective during 2012, but it must be kept in mind that the recruitment process has not yet been completed.

The third wave of ambassadorial appointments also took place this year. As only a quarter of these positions are still pending appointment, the process of transforming the Commission's delegations into EU embassies and naming ambassadors can be considered to be near completion. Similar rapid progress has been made regarding the appointment of EU Special Representatives, to the effect that most diplomatic posts have now been filled and efforts can now be focused on rounding out the mid-level staff required for these missions.

An analysis of the EEAS's performance in 2012 shows that it has managed to carry out the main tasks related to its initial deployment, which have ranged from the rollout of its administrative headquarters in Brussels to the impressive feat of establishing 140 embassies in third countries and international organisations.

With these bases in place, one may say that the EU's administrative framework for external affairs is operational and undergoing constant improvement, although the institutional progress made to date on the CFSP and the CSDP has not been strong enough to rule out the possibility of setbacks provoked by extreme events, such as an eventual rupture within the Eurozone or a long political crisis brought on by clashing points of view or interests. Nevertheless, a basis is being laid for the development of solid and robust policies to be implemented once there is a more favourable environment.

European Institutions and Foreign Policy: The Council, the High Representative, the Commission and the European Parliament

In sharp contrast to the area of economic governance, in which frequent recourse has been made to external treaties in order to move integration forward, the "internal dimension" of the EU has developed strictly within the boundaries laid out in the Lisbon Treaty. This internal progress has moved along at an admittedly slower and more halting pace than that achieved in the area of economic governance and without exploiting its potential in terms of presence, visibility or influence. Council President Van Rompuy, Commission President Durao Barroso, High Representative Ashton and the European Parliament have all done a reasonable job in containing unilateral drifts, but in overall terms, the growth of the EU's role as a global actor in relation to other world powers, as well as in multilateral organisations such as the United Nations and the International Monetary Fund has clearly lost momentum.

The almost exclusive focus on matters of economic governance has left the President of

the Council with insufficient time for those related to foreign policy; therefore, no great advances have been made in that area. The controversy concerning problems that arise from having a "troika" (Van Rompuy, Barroso and Ashton) represent the EU on matters related to foreign affairs has not died down, although this arrangement has the positive side effect of keeping their interest in foreign policy sharp, at times, to the point of rivalry.

In a period dominated by the dynamics of intergovernmental relations – a topic covered in another chapter of this report – the High Representative has maintained her usual low profile; her activities have been centred mainly on reporting on and debating the Council's decisions in the Parliament, overseeing the implementation of external and EEAS missions and addressing questions of doctrine related to foreign affairs and security. Here, once again, Ashton did not fully exploit the attributions and possibilities inherent to her status as a Vice-President of the European Commission.

In March 2012, one year after the launch of the EEAS, differing visions of the service's leadership role in foreign affairs were openly aired during a debate in the European Parliament. At this session, Executive Secretary General Pierre Vimont observed that the EEAS was providing leadership and that its main challenge going forward is to achieve a "comprehensive focus and an integrated dialogue". This theme was taken up again when the HR addressed the European Parliament AFET and SEDE committee meeting on 7 November 2012, during which pending challenges and new missions were discussed.

Although the European Parliament's position with the governments of member states eroded during this period, it was nevertheless active in terms of debates and took positions on important topics such as the need to provide more po-

litical and material support for democratic transition in Arab states. In September 2011, the European Parliament was one of the first political bodies to call for the resignation of Syrian President Al-Assad, and a month later, it issued a statement against the imprisonment of Yulia Tymoshenko in the Ukraine. Actions taken during 2012 included calls for clean and fair elections in Tunisia and the freezing of Arab dictators' assets, support for sanctions against Iran, a call for joint dialogue with members of parliaments in Arab countries caught up in the processes of transition and numerous admonitions directed to Russian officials concerning human rights violations (the Magnitsky case being one example).

Although compelled by the circumstances to devote much of its time to rhetoric, the European Parliament also brought attention to the need for a truly strategic framing of foreign policy geared towards carving out a greater role for the EU in global governance. During the 12 July debate on the Council's annual report on the CFSP, the Parliament urged Catherine Ashton and the member states to work together to forge a more strategic and forward-looking vision, a message that was driven home once again in the Parliament's 12 September resolution on this document. It can be said that the European Parliament is working on an ever-closer basis with the HR to improve this situation. Towards this end, the European Parliament requested that guidelines be drafted for the delegation of specific tasks and missions to core groups of member states and that conclusions be drawn up concerning permanent structured cooperation in security and defence matters and the Mutual Defence Clause.

Human rights and democracy have become a central theme in European discourse on common foreign policy, although there have been meagre results in this area (one example being

the failure to improve Russia's and China's treatment of political dissidents). Following the recommendation of the HR, on 25 July 2012 the Council adopted a strategic framework and action plan on human rights and democracy that drew heavily upon concepts expressed in the joint HR-Council "call to action" Communication titled *Human Rights and Democracy at the Heart of EU External Action – Towards a More Effective Approach*. Concurrent with this initiative, and in response to the insistent demands of the European Parliament's Foreign Affairs Committee, on 25 May the Council appointed Stravros Lambrinidis, a former Foreign Minister in the Greek government, as Special Representative for Human Rights, a new office charged with contributing to the implementation of the action plan. In response to the European Parliament's expressed interest in having a greater role in this matter, the candidate, who was proposed by the High Representative, passed through a parliamentary approval procedure before being officially designated by the Council.

Policies: A General Overview

As already stated, the analysis contained in this chapter covers a period marked by serious internal crisis, a loss of political momentum and shrinking resources, the last of which is made abundantly clear in the budgets of member nations, as well as in the EU budget for 2014–2020, now under discussion. As might be expected, member states' attitudes toward matters pertaining to EU foreign relations fall into two basic categories: a tacit approval of continuity that has on occasions led to differences of opinion that nevertheless never ended in open confrontation. Between the methodical evolution of the EEAS and the fact that Union

took a reactive, rather than proactive posture in response to events, 2012 was another year of much rhetoric and little action.

Generally speaking, the EU's relations with other world powers (strategic partners) have continued to slide on a number of fronts since the beginning of the Euro crisis. The dampening of EU–US relations began with the Obama administration's concern that the crisis in Europe could hinder economic recuperation in the United States, a possibility that prompted US Treasury Secretary Timothy Geithner to lobby hard for European integration at the 16 September 2011 meeting of the Eurogroup and has been the topic of numerous appeals to European leaders by Hillary Clinton. Practically the same can be said regarding China, which has invested in or bought up companies in member countries along the EU's frontiers, such as Greece. Neither has the EU been able to improve the human rights situation in Russia and, despite the bilateral summits between Brazil and the EU held in October 2011 and January 2013, that country continues to have an on-again, off-again attitude towards the euro. Another area in which the EU's influence has waned is the Near East, where Turkey, Saudi Arabia and the Gulf states have widened their spheres of interest and now enjoy considerable influence.

We will now move on to a brief overview of those areas in which the European crisis has had the greatest impact: the Americas and neighbouring Arab countries:

EU relations with the United States have a special relevance in the context of the current crisis, given that the initial event that precipitated the crisis – the collapse of Lehman Brothers in 2008 – took place in that country. That said, it must be admitted that the crisis has not been handled well in Europe, where, instead of implementing a stimulus programme similar to

that put in place by the Obama administration, leaders opted to impose austerity measures, a misguided strategy that has had deep and lasting negative repercussions. Nevertheless, the divergent approaches taken by the United States and Europe have not supposed a basis for open confrontations between them. While common solutions may have temporarily been slow to emerge, some initiatives such as the High Level Working Group on Jobs and Growth established at the 28 November 2011 EU–US Summit, which was designed to simultaneously boost transatlantic trade and investment and create employment, are moving forward. An interim report on this project submitted in June 2012 now serves as a consultation document and a reference for the final report due at the end of the year. These efforts have given a renewed impulse to the Transatlantic Economic Council (TEC).

Another part of the world in which EU foreign relations have been affected by the crisis is Latin America and the Caribbean. Special attention should be paid to the fact that this region has continued to attract high levels of investment and enjoyed a 4 per cent rate of growth in 2012 compared to a near total halt in investment in Europe during the same period. Delays have had a great impact on the Bi-regional Strategic Partnership, hobbling the action plan approved at the 2010 EU-CA Summit held in Madrid to the point that the summit originally scheduled to be held in Santiago de Chile was rescheduled for January 2013 out of fear that the deep crisis in the Eurozone and the lack of any significant progress could derail the entire project. Nevertheless, this process did open up channels for bi-regional cooperation and value-added investment. There has also been progress on other fronts: in December 2012 the European Parliament ratified a multiparty free-trade

agreement between the EU, Colombia and Peru and the Comprehensive Association Agreement between Central America and the European Union; Peru has ratified these agreements and Colombia is expected to do so by early 2013. This progress stands in sharp contrast to the slowdown in negotiations towards an association agreement with MERCOSUR. Another issue that has had an impact on EU relations with Latin America and is also partly linked to the crisis is the European Commission's controversial new financing instrument for development cooperation, a reform measure implemented in 2011. With the objective of rebalancing European aid to the region, the EU has adopted a differentiation principle that pegs assistance to a large degree on a country's GNI per capita, a change that implies phasing out bilateral programmes with large middle-income countries, such as Mexico, Brazil and Argentina and Andean countries, such as Colombia. On an institutional note, it has been observed that bridges between the EEAS and Latin American integration frameworks such as UNASUR and CELAC are weak and require further development.

Considering the magnitude of the Union's internal crisis, 2012 has not been a particularly bad year for EU policy focused on the Mediterranean region and the Union's Arab neighbours. As mentioned in another chapter of this report, agreements have been reached for the implementation of various programmes related to economic cooperation, education and mobility.¹ However, the EU has dragged its feet in implementing assistance programmes, and when it

has done so, it has allocated insufficient resources towards the reconstruction of countries such as Egypt, Tunisia and Libya. In addition to the consequential decline of Europe's influence (mentioned elsewhere in this report), which has been appropriated piecemeal by other states in the region, one must also take into consideration the image of Europe that is catching hold in the countries of the Southern Mediterranean rim, where, due to the limited horizons for European cooperation, the EU is increasingly being perceived as weak and lacking a robust strategy for the region.

On a final note, it should be noted that, in spite of the crisis, the Common Defence and Security Policy has undergone a certain degree of revitalisation since 2011. During 2012, three new civilian crisis management missions were launched: EUCAP NESTOR in the Horn of Africa, undertaken in mid-2012 and scheduled for termination in August 2014; EUCAP SAHEL Niger, also scheduled for mid-2012 to August 2014; and EUAVSEC South Sudan, launched in mid-2012, which will be operational until January 2014. At its 10 December 2012 meeting, the Foreign Affairs Council also approved an international assistance mission to Mali (MISMA) for the purpose of providing military training to the Malian Armed Forces in anticipation of the French intervention planned for January 2013 in concert with ECOWAS forces. Other civilian missions are also planned for 2013, including a mission designed to help Libya improve its border security.

Enlargement: Slow Progress

Somewhat paradoxically, at a moment of obvious internal fractures within the European Union, its enlargement process is moving steadily

¹ For more information on the European Neighbourhood Policy for the Mediterranean and Eastern European countries, see the chapter of this volume titled »The European Neighbourhood: A policy for the EU's southern and eastern neighbours«.

ahead and is currently one of the most successful facets of EU foreign policy. Under the leadership of Stefan Füle, the commissioner in charge of this area, the EEAS acts as the coordinator of the application processes of nine countries that were candidates, or potential candidates, for membership during the year covered in this volume. The advances made by these candidate countries during 2012 are as follows:

- **Croatia** signed an accession treaty in December 2011 and, if pending ratifications of member states are carried out in a timely manner, will become a member in June 2013. As of the end of September 2012, only 13 member states had ratified the treaty. Upon its accession, the EU will comprise 28 member states.
- **Turkey** submitted its application for membership in 1987 and the negotiations for its accession began in October 2005. Thirteen chapters of this candidacy remain open, and only one has been closed. In March 2012, the Commission launched a “positive agenda” to revitalise its accession process. Nevertheless, there is growing concern regarding Turkey’s failure to make progress on political criteria and human rights issues, especially those related to freedom of expression. The full implementation of obligations related to a proposed customs union and further progress towards the country’s normalisation of relations with Cyprus are also pending issues. On the other hand, although the general public perception in Europe is that Turkey has lost interest in EU membership, in November 2012, Turkish Prime Minister Recep Tayyip Erdogan published an article in which he clearly reiterated that Turkey’s rapid accession continues to be a national priority.
- **Iceland** submitted its application for membership in 2009 and entered into negotiations in June 2010. Eighteen chapters have been opened, of which 10 have been closed. The progress towards this country’s accession has been rapid given that as a member of the European Economic Area (EEA) and the Schengen Area, much of its legislation has already been harmonised with that of EU countries. Significant progress was made towards its accession in 2012.
- **The Republic of Macedonia** submitted its application in 2004 and has met all necessary political criteria. However, despite repeated recommendations from the Commission (2009, 2010 and 2011), it is embroiled with an ongoing dispute with Greece regarding its name and due to this member’s veto, no formal negotiations have been opened. During the final months of 2012 there appeared to be some movement on this issue, and the Commission pushed once again for negotiations to begin on the basis that the dispute concerning the name could be settled as talks progressed.
- **Serbia:** The Council voted to recommend Serbia’s candidacy in March 2012. While it is expected that negotiations will begin soon, the Commission insists that Serbia must first improve its relations with Kosovo.
- **Montenegro:** This country became a candidate in June 2012 and negotiations for its entry are expected to start soon. It submitted its application in 2008.
- **Albania, Bosnia Herzegovina and Kosovo:** These states acquired the status of what the Commission refers to as potential candidates in 2012. The first two submitted their applications in 2009 and 2010, respectively, and the third has yet to do so in view of the Commission’s opinion that although it has made progress, it does not yet meet the criteria to enter into negotiations.

Returning to earlier observations regarding the progress that has been made on this front, despite the deep crisis the Union is currently dealing with, it is worth noting that a growing number of countries are expressing interest in being a member of the club, which goes to show that although the weather may seem rough at the moment to member states, in the eyes of the countries on the outside looking in, the climate is much more hospitable within the Union.

It is abundantly clear that the doubts surrounding the pending application of Turkey must be resolved one way or the other and that the Union must come up with a meaningful posture on its candidacy. Once the Union sends this country a clear message and a firm and detailed schedule, it will be easier to push for fulfilment of the requisites for accession.

In any case, the fact that so much progress was made in relations with candidate states was one of the highlights of 2012. The Union has a clear position that is being ably expressed through the EEAS, an instrument that is exercising its normative powers; in this instance, the power to move states and societies down the path that leads to democracy, respect for human rights, political stability and economic prosperity.

Policies and Representation in Multilateral Institutions

Bringing the EU's political weight in multilateral forums up to par with the combined economic weight of its 27 members continues to be a pending assignment. In this respect, the crisis has certainly not furthered Europe's ambition of becoming a single, unified player in world events. It is important to stress that internation-

al circumstances, such as the economic crisis, the turbulence in the Arab world and the inflexibility of emerging nations – all weighty factors – have not made things easy for the Union. None of these situations took a hoped-for turn for the better in 2012, and the EU failed once again to seize the opportunity they presented to carry out the dual tasks it must inevitably undertake in organisations and forums such as the UN, the IMF and the G20, which are, on one hand, to simplify its representation and coordinate positions, and on the other hand, to bring these institutions and their policies more into line with European points of view and interests.

Against this backdrop, there is evidence of a growing awareness on the part of European leaders that the Union must position itself better in multilateral organisations in order to exert a stronger and more positive influence. On that point, the EU has fought desperately to make a virtue out of necessity in the multilateral arena. In the area of economics, it has attempted to shake off the negative image of being the epicentre of the crisis with strategies such as providing leadership for the Growth and Jobs Action Plan at the G20 Summit in Los Cabos, Mexico last June. In the policymaking arena, the Union has served as a political and legal umbrella for the UN on various fronts, attempting to break the deadlock between Palestinians and Israelis, threatening the Iranian government with sanctions in an effort to persuade it to abandon its uranium enrichment plan and even assuming a role in the reconstruction of Libya and the civil war in Syria.

Although the UN's plans for a massive reorganisation of its structure and finances remain on hold for the foreseeable future due to positions taken by various superpowers, it might have been expected that it could at least look forward to the EU's entry as an observer and

from October 2011 count on a unified European voice, in the person of Herman Rompuy, to ring out loud and clear in the General Assembly. However, one year later, on 29 November 2012, on the occasion of the General Assembly's crucial vote on the admission of the Palestinian Territories as an "observer state", this unified voice failed to materialise when European nations each went their own separate ways on the issue. Fourteen member states (including France, Spain and Italy) voted in favour, 12 abstained (among them Germany, the United Kingdom and the Netherlands) and the Czech Republic voted no. In a repeat of earlier situations, it had been impossible to coordinate a planned, unified position going into this important session. Likewise, when the HR attempted revive the "Madrid Quartet" (the United States, Russia, the EU and the United Nations) in a gambit to achieve a binding agreement on the Israeli-Palestinian question in 2012, she, too, came away empty-handed.

Practically the same thing occurred during the sixty-seventh regular session of the General Assembly of the United Nations, where there was a marked contrast between the EU's low profile (and the minimal results it achieved) and its robust physical presence; although it must be said that the appearance of the "troika" at the General Assembly meeting and the presence of Vice-president of the European Parliament Othmar Karas at the Inter-Parliamentary Union meeting together supposed a significant institutional step forward.

Since the situation in Libya became minimally stable, there have been no new Security Council resolutions on or new missions to that country – not even in response to schisms provoked by the United Nation's Security Council's Resolution 1973 in March 2011. Nor have there been significant advances in the political, economic and

social reconstruction of that country, due in great part to the meagre joint European contribution to post-war recovery. Syria has been a slightly different story. In October 2011, the twenty-seven member states of the EU joined together to draft a UN Security Council resolution condemning the government crackdown in Syria, which was subsequently vetoed by China and Russia. Nevertheless, the European block was able to win concessions from China, which issued a declaration on the Syrian government's disproportionate use of force. This subject was addressed by various European Councils throughout 2012, all of which made statements in favour of the resignation of Bashar Al Assad and a change of government in Syria.

In contrast to these frustrated initiatives, for the second consecutive year, important advances in cohesion amongst the member states and results were achieved regarding questions pertaining to Iran. Although there was very little progress towards changing the policies of the Iranian government, the EU never strayed from the UN Security Council's legal framework and showed a firm determination to maintain its position on nuclear issues, implementing a ban on the import, purchase and transport of Iranian petroleum in January 2012 with the full support of all 27 members, in addition to passing a resolution calling for the International Atomic Energy Agency to impose sanctions on that country. A range of tough sanctions pertaining to the importation of Iranian crude, the mobility of high Iranian officials within EU territory and the freezing of Iranian assets brought continuous pressure to bear on the Ahmadijenad government.

The previously mentioned EU mission to Mali involves mainly France and a coalition of European partners working as a cohesive unit. Nevertheless, it is important to point out that the EU sought UN approval for its actions and framed

them in accordance with the UN Security Council's Resolution 2085 of 20 December 2012, which authorised the EU's training mission, as well as the MISMA intervention carried out under ECOWAS command. This comes in the wake of a number of precedents to the January 2013 intervention that attest to the EU's concern about the situation in this country, such as the *European Union Strategy for Security and Development in the Sahel*, approved and adopted by the European Council in March 2011, and the warning issued by the ACP–EU Assembly 28–30 May 2012 concerning arms proliferation in the Sahel region following the conflict in Libya.

There has not been significant progress towards pooled representation in the International Monetary Fund (a single seat for EU countries that would give the countries of the Eurozone a single voice), a major disappointment considering that this institution is a key player on such issues as the management of the debt crisis, assistance funding to member states and the evolution of the role of the European Central Bank. The prior intentions of the IMF's Executive Committee to create two European seats – one for Eurozone states and the other for non-Euro states – have been put on hold for the moment due to problems in the Eurozone.

Instead, attention has been focused internally on the ECB, which has been strengthened and has progressively shown more muscle. The ECB has made massive purchases in the bond market and will have powers to act as single supervisor of European banks as of 2014 on a par with the Eurogroup, which should result in sounder fiscal and financial decisions. A number of carefully couched proposals on improving internal operations and representation geared towards improving the speed and effectiveness of decision-making are being generated by both institutions, including some that address the

fundamental question of their relations with non-euro partner states. At this point, efforts are being focused on the configuration of the future external representation of the Eurozone and how this would function in practice.

In terms of economic policy, the IMF has continued to take a laxer approach to monetary policy than the ECB. However, the Eurozone has lacked the appropriate instruments to carry out a monetary policy during this period. As was the case under her predecessor Dominique Strauss-Kahn, there have been discrepancies between the current Director of the IMF, Christine Lagarde, and the European Commission and the Eurogroup regarding the EU's macroeconomic forecasts and its plans for overcoming the crisis and Lagarde has constantly issued statements in favour of policies designed to stimulate growth.

The EU's activity within the scope of the G20 is best described as underwhelming, as no progress has been made towards institutionalising this forum or making its agreements binding on either programmatic issues (macroeconomic coordination, the financial system, tax havens and employment) or organisational issues. Fortunately, the EU's performance at the summit held in Los Cabos, Mexico on 18 and 19 of June 2012 was better than the one it gave in Cannes in November 2011, when the lack of a European consensus on priorities to be established for resolving the crisis during the French presidency of the G20 was embarrassingly obvious. In response to urgent petitions on the part of other members of the G20, the EU came out firmly in support of a declaration in favour of economic growth and employment and reform of the financial system at the Mexico summit. There was much expectation that an encounter between Barak Obama and François Hollande – two leaders in favour of economic growth – could move events and that Hollande's proposals would be

considered a viable alternative to Angela Merkel's austerity programme. An outgrowth of this sentiment was the Growth and Jobs Action Plan, which at least in terms of rhetoric, opened the doors to a new approach to economics in Europe and a new basis for its relationship with both major and emerging world powers via the transatlantic High Level Working Group on Jobs and Growth.

Recommendations

Based on the preceding analysis, we offer the following recommendations for strengthening the EU's external positioning and putting the Union "back on the map" as a major world player.

General Foreign Policy and Strategy

- Given that the United States and Europe have the two most integrated economies in the world, it would make sense to work closely with the Obama administration on the development of concerted solutions to the crisis and to make the most of the High Level Working Group on Jobs and Growth, which can provide a good opportunity for making progress on a free-trade agreement and the regulation of a transatlantic market.
- Forge a joint strategy for Latin America – a rising region – that gives European institutions a higher profile. Coordination between the EEAS and regional integration frameworks should be a high priority.
- It is essential to articulate a coordinated, pan-European action strategy for the Sahel, a region that the Mali crisis has clearly shown

to be a security risk for all Europeans, rather than relying on the strategy pursued by a single country. This will entail the implementation of a revised strategy for the region that includes preventative and military measures and development programmes.

- Strengthen internal agreements on matters related to foreign affairs on which there is consensus with an eye to developing a unified European voice on important issues. Developing common positions is one the keys (although not the only one) to forging a successful EU foreign policy. It must be kept in mind that small successes generate virtuous loops of self-confidence and consensus.
- Speed up the process of updating the European Security Strategy ("A Secure Europe in a Better World", issued in 2003 and revised in 2008), clearly outlining a coherent role for the EU that reflects today's strategic global environment, so that it can be implemented in 2013 in line with decisions taken at European Council in Brussels in 2012 concerning the PSCD.

Instruments

- Establish cooperation arrangements during 2013 between various member states along the lines of the enhanced cooperation outlined in Title IV of the TEU and Article 327 of the TFEU) with an eye to boosting the EU's external representation and progressively cede competences and tasks to the Delegations of the European Union in different countries, the United Nations or the EU representation in the IMF or the World Bank.
- The European External Action Service (EEAS) should be strengthened on issues and in re-

lation to geographic areas on which consensus among members is fragile or there is no consensus (for example, nuclear issues, defence, the Israeli-Palestinian question, the Balkans, Turkey, Cuba), in order to resolve differences and pave the way for compromises. The issue of visibility needs to be addressed, beginning with an overhaul of the EEAS website, which must be improved. Co-ordination also needs to be improved between the EEAS and the Commission, member states, foreign affairs ministries and embassies. Along the same lines, it is essential to strengthen not only the European Parliament's collaboration with the HR, but also with other EEAS officials and even with ambassadors to foster their participation in relevant sessions, especially those of the Foreign Affairs Committee. On a final note, it can also be hoped that the EEAS will be more pro-active in the planning of foreign policy.

European Institutions

- The troika (Van Rompuy, Barroso and Ashton) should coordinate activities related to foreign policy in order to fill in gaps that exist due to a lack of resources. Experience has shown that a lack of initiative can be more disadvantageous than overrepresentation.
- Ensuring effectiveness and democratic control should be priority goals for the Parliament and any initiative to improve institutional control should be undertaken in advance of the 2014 European Parliamentary elections. In this moment of institutional decline, it is essential to revitalise the European Parliament in the interests of sound foreign policy. Majority political parties should draft proposals for 2014 regarding improved oversight of foreign policy. The Parliament should strengthen its committees and schedule more appearances by the HR and the presidents of the Commission and Council; it should also work hand in hand with the EEAS to promote an enhanced "parliamentary diplomacy" between the Parliament and international organisations.
- The Council, through its president, should have a more active role in defining foreign policy strategy and should call upon the Commission and the High Representative to work together to produce a programmatic document along the lines of *Towards a Genuine Economic and Monetary Union*, which was authored by the "quartet" formed by Van Rompuy, Barroso, Juncker and Draghi).

International Organisms

- The EU should present an initiative in the UN to endow regional integration organisations (RIOs) with greater capacities; although these organisations are already recognised by the UN, strengthening their legal status would be a stimulus for the EU to be more consistent in this area. This status would apply to various organisations that are strategically important for the EU at this point in time, such as UNASUR and ASEAN, should they decide to assert legal personalities in their capacity as RIOs.
- During 2013, the states of the Eurozone, including Spain, should initiate a process to institute a single constituency for the euro on the board of the IMF and work to strengthen the attributes of the ECB and the Eurogroup. This will give the Eurozone greater weight in the IMF and elsewhere as well,

extending the Eurozone's influence and facilitating a cohesive defence of the euro. Nevertheless, to be effective, these institutional advances must be backed up by a higher level of internal operational agility in order to streamline the process of forging consensus on macroeconomic, fiscal, finance and Eurozone policies and make it possible to channel decisions more quickly and effectively through the IMF and the G20. The influence that the EU gains through a single constituency in the IMF will depend to a great degree on the strength or weakness of the ECB; therefore, we highly recommend strengthening its attributes through concrete actions that could be taken as much in its capacity as a single supervisor as in its capacity as a lender of last resort or guarantor of credit with an eye to releasing pent-up demand. This would create a virtuous circle between the two institutions.

- Building on the momentum of its progress on debt reduction, financial restructuring, banking supervision, labour market reforms and competitiveness, the EU should push the agenda for global growth forward at the G20 Summit in Saint Petersburg, Russia, scheduled for September 2013. It would also make sense for the EU use the summit as an opportunity for proposing to other advanced economies that social indicators such as expenditure on educational and occupational reinsertion plans be factored into the progress reports required by the Los Cabos Accountability Assessment Framework. This could be done with the assistance of the United Nations Economic and Social Council (ECOSOC) or another advisory organisation created specifically for this purpose.

Conclusions

Looking back, it can be said that 2012 marked the year that the EU put in place and defended policies on foreign affairs, security and defence, although these policies still have a long way to go in terms of constituting and furthering a genuinely common European policy.

For the EU, 2012 was a period of self-absorption and introspection that produced more rhetoric and good intentions than effective actions and clear messages. Nevertheless, this does not add up to time lost in terms of external affairs. Although the political slowdown has prevented the EU from assuming a greater role in world affairs, taken together, progress on instruments such as the EEAS and the continuity of interaction between community institutions (the Council, Commission, High Representative and the European Parliament) offer a more positive perspective on what was accomplished during this period.

The EEAS was created as a means of giving unity, coherence, visibility, effectiveness and consistency to the European Union's foreign policy. Although still a fledgling institution, it has been vastly improved by the creation of the position of High Representative and the realisation of its external service, which as an implementing mechanism is gradually imbuing the Union's discourse in this area with a certain degree of unity, coherence and consistency. The external service functioned reasonably well throughout 2012; despite its short track record, it is making a place for itself in the broad constellation of foreign affairs.

What is failing, however, is the policymaking process, which at the moment is in the hands of member states and therefore depends on the Foreign Affairs Council, which, as is well known, operates on the basis of unanimous decision.

No one should be surprised by the difficulties involved in reaching foreign policy decisions, especially considering the overall circumstances that decision-makers had to deal with throughout 2012 that made arriving at any decision a challenge. In any case, reaching a consensus on foreign policy is always difficult, regardless of the circumstances. The fact that the EU's foreign policy is not producing the desired results does not mean that the EASS is not fulfilling its task. The most important thing is that a European diplomacy has finally been established and is being progressively implemented, so that when the circumstances that are hindering the routine operations of the Union change for the better, it will be in full gear and ready to move ahead.

There is a general consensus that the High Representative and the EEAS both suffer from a visibility deficit, especially in terms of media visibility. Another pending issue is the lack of internal coordination between the EEAS and the Commission, and even more importantly, between the EEAS and member states. The lack of coordination between the latter two is the most difficult to correct, given that, although the Treaty establishes coordination between the EEAS and the national diplomatic corps of member states, it does not provide the Union with instruments to carry out such coordination. If we consider the fact that member states do not always feel comfortable about the existence of this new body, we can begin to understand the real difficulties that crop up in attempting to establish coordination between national diplomatic services and the EEAS, both at central headquarter and embassy levels. Achieving optimal relations between the embassies of the EEAS and the embassies of the individual member states will not be an easy task. At times one gets the impression that to a certain degree, these diplomatic corps tend to compete with

one another. It should not be forgotten that, before the EEAS was established, the political aspects of foreign policy implementation were carried out through the embassies of states that temporarily held the rotating presidency.

The internal dynamics of the troika in matters relating to the external representation of the EU and the European Parliament have been consolidated, which has sparked a degree of rivalry over which of the three will be the protagonist in a given situation. However, this consolidation has paved the way for improvements in a number of areas, among them the EASS, support for democratic transition in Arab countries and respect for human rights.

The EU has made slight progress in the areas of its foreign policy that the crisis has affected most: its relations with the United States, Latin America and the Arab Southern Neighbourhood countries, although it also has failed to take advantages or opportunities in these areas. Progress has been made in the area of enlargement: a positive sign that the European project continues to be an attractive proposition to other countries. Although the EU has not yet taken full advantage of multilateral institutions, it has at least been able to use the United Nations as a platform for expressing its views on a number of important issues, such as the Israeli-Palestinian conflict, the Iranian nuclear programme and conflicts in Libya, Syria and Mali. The crisis has modified the EU's expectations with regard to its role in the IMF and the G20; it has refocused its priorities towards improving its internal operations and representation for blocks constituting euro- and non-euro states. It can also be acknowledged that the EU's interactions with the IMF, the G20 and other countries have served to exert pressure on the Union to orient its economic policies on both responsibility and growth.

The Economic Crisis and the EU's Security and Defence Policy

Jordi Marsal

Introduction

Throughout 2012, the economic crisis and doubts regarding the future of the euro had an impact on the security and defence policies of the EU and EU member states, as well as on their public policies.

The first visible sign of this impact was budgetary cuts in the area of defence, which varied from country to country and follow a downward trend established over the past few years.

Shrinking defence budgets have led the majority of these countries to commence or intensify the reorganisation of their armed forces, which has entailed reducing military and civilian personnel, modifying organisational structures, reducing arms acquisitions and decommissioning or mothballing existing systems. In some cases, it has also meant lowering levels of participation in foreign operations or even advancing scheduled withdrawal dates of deployed troops.

This spiral of budget cutting has also entailed a commensurate lowering of military ca-

pacities. The current response to this dangerous situation – which could limit the EU's capacity for external intervention and therefore reduce its role in world affairs and important spheres of interest – is focused on the implementation of »pooling and sharing« measures designed to facilitate capacity sharing and joint arms acquisition processes and maintenance programmes.

These budgetary cuts and diminishing arms acquisitions are also affecting the prospects of the European defence technological and industrial base. European countries and companies are rethinking their industrial and commercial strategies with an eye to internationalising activities and strengthening their export capacities in this sector, although national interests continue to complicate many of these processes. The failed attempt to negotiate a merger between EADS and British Aerospace Systems is a prime example of the stalemates that occur when the need to reach a competitive critical mass is weighed against national interests.

Third, media coverage of the crisis and reduced interest in Europe in general and in cer-

tain European countries in particular, has hindered implementation of the EU's fledgling Common Security and Defence Policy at an institutional level, slowing efforts to build military and civilian capacity and hobbling the European Defence Agency's (EDA) day-to-day activities in the areas of technology, industry and the future single defence market.

The day-to-day operations of the EDA present opportunities for reaching routine agreements, the majority of which may only resolve minor issues but nevertheless propel policy-making processes. The launch of the European External Action Service can also be considered a milestone. However, the groundwork laid by these achievements has not been sufficient to overcome the differing national interests that make defining a genuine but effective joint policy based on common interests and in line with the common values of the European Union a continuing challenge. This status quo continues to hinder the implementation of institutional mechanisms stipulated in the Lisbon Treaty, such as Permanent Structured Cooperation, and has hampered the operations of well-organised EU external missions, as well as those in which European countries participate under UN or NATO command. It has also had a negative impact on the deployment of new missions, such as the recent mission to Mali.

These problems also have a bearing on the EU's aspirations to assume a major role both in world affairs and in coping with major scenarios that continue to unfold in its immediate neighbourhood, as the EU's reduced intervention capacity and inability to define common policies on international issues give other important international actors – such as the United States, China and the so-called emerging countries – a negative impression. This situation has become less and less tenable in light of the shifts in pri-

orities and strategies articulated by the US government in policy statements issued throughout 2012 (Sustaining US Global Leadership: Priorities for XXI Century Defence, Defence Budget Priorities and Choices, Joint Operational Access Concept and 2012 Army Strategic Planning Guidance).

Budgets and Capacities at the National Level

The international security landscape is undergoing profound change, driven by a range of factors, such as shifts in American priorities, the continued growth of China, the aspirations of emerging countries and the consequences of the economic crisis. These changes are creating new points of tension and possible conflict, as well as redefining existing conflicts. Against this backdrop, we are witnessing the growth of defence budgets and increased military acquisition in areas such as the Pacific, the China Sea and Southeast Asia, Latin America and the Persian Gulf.

Nevertheless, in the wake of an economic crisis marked by budget deficits and high levels of public debt, military expenditure has been steadily declining in the Western world: since 2008, the overwhelming majority of European countries have progressively reduced their military budgets, a policy also adopted by the United States in its 2012–2013 budget.

Although the nature of the budgetary changes make it difficult to arrive at precise figures for reductions in defence budgets throughout Europe, it is clear that EU countries have adopted multiyear plans that include reductions in military spending as part of their general plans for reducing the public deficit. Activities in 2012 related to these cuts are reflected in a

number of high-level documents, such as the French White Paper on Defence and National Security, the UK parliamentary report First Review of National Security Strategy 2010 and Spain's Joint Chiefs of Staff (JEMAD) report Joint Vision 2020.

Budgetary cuts for 2012 ranged between 1 per cent and 10 per cent in most Eastern and Central European countries, the United Kingdom, Italy and Spain. There were exceptions, however: France increased its budget by 1.8 per cent and Poland is planning a 6.8 per cent increase in its budget for 2013.

Budget reductions implemented in 2012 and approved for 2013 call for a number of measures, including:

- a reduction of military and civilian personnel;
- a reorganisation of armed forces and management structures at the ministerial level;
- a reduction in investment and a decline in the procurement of weapons systems;
- the negotiation of sales of defence systems to third countries that have made acquisition commitments;
- the elimination of older systems with an eye to reducing maintenance expenditures and the freezing of non-priority systems;
- the sale of installations as part of a process of concentration and rationalisation of resources.

As a result of this process, priority is now being given to the maintenance of essential capacities and capacities required for dealing with new and unconventional threats, such as terrorism, diverse catastrophes and increasingly sophisticated cyberspace attacks. In addition to efforts to meet these challenges, on 5 June 2012 the EU launched negotiations on its initiative for an International Code of Conduct for Outer Space.

Budgets and Capacities at the EU Level

The EU's allocation to the CSDP – earmarked for the EDA, routine operations and the Community's contribution since 2004 to missions carried out through ATHENA – represents only 0.03 per cent of the CFSP budget, which itself accounts for a mere 0.4 per cent of the total EU budget. These budgets, which fall under expenditure heading 4 – »Global Europe« – of the general EU budget, are unlikely to be increased significantly over the next few years, given that the multiyear financial framework for 2014–2020, approved at the end of 2012, allows for budgets under this heading to rise from 9.4 billion euros in 2014 to 10.63 billion euros in 2020, a total expenditure of only 70 billion euros over seven years. This budget was raised from 9.403 billion in 2012 to 9.583 billion for 2013, which represents an increase of 1.9 per cent.

It has become increasingly difficult to ensure that member states fulfil their paper commitments to provide the military and civilian personnel essential for maintaining the field capacities stipulated in Global Objectives.

The EU is also struggling to maintain civilian capacities. Following agreements reached by the Foreign Affairs Council on civilian capacities and the presentation of the High Representative's report, at its 13–14 December meeting the European Council asked the High Representative and the Commission to develop further proposals and measures to improve the availability of required military and civilian capacities and to report on progress made by September 2013 in anticipation of the European Council's December 2013 meeting.

Ensuring that two battle groups are on standby for every six-month period has also been difficult. During the first half of the year,

only one (led by France) was in place. During the second half of the year there were two on standby: one led by Germany and the other by Italy. One group per six-month period is scheduled for 2013, but as of the writing of this chapter, neither is in a state of readiness and there are doubts concerning these groups' effectiveness and efficiency, should the need for deployment arise.

EUROFOR's general headquarters was officially closed on 14 June 2012 and although EU-ROMARFOR continues to be operational, this force officially ceased to exist as of 2 July.

The European Security and Defence College has continued to coordinate educational and training activities for the military personnel of member states and to consolidate its network of institutions in those states and training centres throughout the EU (European Police College, Europe's New Training Initiative for Civilian Crisis Management, European Union Police Services Training and EDA supported training activities).

Pooling and Sharing

The shortcomings of relying on individual states to cover capacity requirements have led to a growing number of agreements on initiatives to remedy this problem at the EU level, such as the revitalisation of the 1991 Weimar Triangle in 2010 and the German–Swedish accord that paved the way for the Ghent framework for pooling and sharing, as well as independent agreements between states, such as the defence treaty signed by France and the United Kingdom in 2010 and a bilateral agreement between Germany and Italy. In September 2012, 11 nations launched the »Future of Europe Group«, which has issued a comprehensive series of recommen-

dations, one of which calls for strengthening the CSDP. These initiatives have emerged alongside a growing trend towards a multi-speed or »variable geometry« Europe and a general perception that policies constitute a set of tools to be used according to the needs of each situation and the varying positions held by individual member states.

Nevertheless, the most significant initiative related to the pooling and sharing of capacities and the development of joint procurement processes grew out of the September 2010 meeting of European defence ministers in Ghent. On 23 May 2011, the Permanent Committee of the European Defence Agency called upon the agency to analyse projects and subsequently draft a list of priorities for cooperative capacity-building initiatives.

At its 22–23 March meeting, the Foreign Affairs Council approved a series of cooperative initiatives involving interested countries, which are now moving forward at different speeds. Significant progress was reported in several areas, including aerial refuelling, medical support, training (counter-IED measures, helicopter training and air transport crew) and maritime surveillance. However, the Council also called for further efforts in ISTAR, future military commercial satellites (SATCOM), smart munitions and naval logistics.

Progress has also been made in cooperation between the EU and NATO on the Smart Defence Project, one of the central topics discussed at the 19 April meeting of NATO defence ministers. The importance of this cooperation, which is essential for eliminating duplications of effort and unnecessary expense, was stressed at the Chicago NATO Summit held 20–21 May.

The need to intensify cooperative efforts and factor them into national defence planning was brought home once again during the infor-

mal meeting of EU ministers of defence convened 26–27 September in Cyprus.

A code of conduct for pooling and sharing proposed by the European Defence Agency was accepted at the 19 November meeting of the Foreign Affairs Council.

It should be pointed out that, although some programmes have run up against great difficulties, others – such as the helicopter training programme – are moving ahead at an excellent pace. Two important exercises were conducted in 2012: the fifteen-day Hot Blade exercise, starting on 4 July in Ovar (Portugal), in which 2,700 personnel from seven countries participated, and the three-week long Green Blade exercise, organised by the Belgian Ministry of Defence in cooperation with Luxembourg, which involved 500 personnel from four countries who carried out 49 missions, representing a total of 487 flight hours.

European Defence Agency

Despite its meagre budget (30.5 million euros), the European Defence Agency is evolving into the principal instrument of the CSDP; the meetings of its permanent committee presided over by the High Representative fulfil the functions of a genuine council of defence ministers, entrusted with the decision-making and management of the EU's policies related to capacity.

On 31 January, the Annual Conference of the EDA convened to deliberate on a new approach to defence based on cooperation to mitigate the restrictions on defence expenditure caused by current budget restrictions.

The processes entailed by pooling and sharing were the main focus of the conference and although no codes other than that developed for this area have been announced for the defence

sector and market, as in previous years, information was provided to raise European companies' awareness of contracting opportunities related to member states' defence procurement processes with an eye to increasing the competitiveness of the sector and progressing towards a single European defence market. To this end, nine continuously updated portals that offer information about contracting opportunities, logistic support, the standardisation of IT systems, offsets, supply security and other areas have been created.

European Defence Technological and Industrial Base

The budget cuts made in response to the economic crisis and new strategies for increasing cooperation between countries present new challenges for European industry. Furthermore, cuts in US defence spending will have an impact on American industry, which will inevitably translate into tougher competition between companies in the international marketplace, especially in calls for tenders issued by countries in which heightened tensions are causing governments to ramp up defence spending. Measures taken by the Council (related to the EDA's code of conduct) and the Commission (via directives and interpretations that are being incorporated into legislation at the national level), intended to pave the way for a single market freer of restrictions, have also increased competitiveness within the European defence market over the past few years.

This new scenario pits the need to achieve a higher critical mass of defence-related businesses through mergers and takeovers that may even entail the creation of supranational companies against the desire of many countries to maintain national capacity levels in a bid to

guarantee a degree of autonomy and strengthen their companies' positions in both domestic and international markets. This situation not only affects large, domestic flagship companies, but also small- and medium-sized enterprises in the sector.

In 2012, we witnessed a clear example of how the best-laid plans can break down in this new scenario. EADS and British Aerospace systems, the two largest companies in their sector, decided to undertake a merger that would allow them to capitalise on the synergies between the two firms in various industrial and technological areas (both military and civilian), achieve a higher level of critical mass through penetration of a diverse range of markets and improve their position in an increasingly competitive market.

Nevertheless, the conflicting perspectives with regard to national interest of the relevant governments derailed the merger. This turn of events has had an impact on the strategies and even the future market value of the companies in question. This was definitely the case with EADS, which will now undergo a major shareholder restructuring while promising that:

... certain French and German national security interests will be protected through the creation of »national defence companies« holding sensitive military assets, and including the rights of France and Germany to consent to three outside directors to the board of their respective »national defence companies«. Two such directors of each »national defence company« shall be members of the EADS board.

The initial consequences of this restructuring will become obvious in 2013.

External Missions

Building and maintaining military and civilian capacities are not ends in themselves, but rather the processes that make external missions – the CSDP's most visible work – possible. In line with the integrated approach espoused by the EU, these missions are conceived to perform multi-disciplinary functions. However, in practice, due to the specific nature of the requisite expertise and the EU's vision of its role in world affairs, EU military missions – with the exception of Operation Atalanta – have been limited in terms of their scope and objectives compared to civilian-oriented missions.

Africa has become a major priority, in large part due to the development of serious problems in the Sahel region.

At the 23 March 2012 meeting of the Foreign Affairs Council, conclusions on the EU's strategy for the Sahel region were adopted and a commitment was made to intensify EU operations in this zone, which spans Africa from the Atlantic to the Indian Ocean. The EU also maintains a presence in the least stable area of Central Africa (Democratic Republic of the Congo through EUSEC-RDC) as well as Mediterranean Africa, in what is referred to as the MENA zone (the Middle East and North Africa). This zone has been turbulent due to the events brought on by the Arab Spring, ongoing confrontations along the Israel–Palestine border that could escalate depending upon how situations in the Arab Spring countries evolve and, most importantly, the development of the civil war in Syria. Neither the international community as a whole, nor the EU as a block, has been capable of intervening effectively in the latter conflict, which threatens to join Mali on the list of the world's failed states. Both countries are located in what the EU considers to be its immediate neighbourhood.

Various missions have been carried out in this zone. The EU was directly responsible for the EUPOL COPPS and EUJUST LEX missions in the Palestinian Territories and Iraq and also participated in the UNIFIL mission in Lebanon under the mandate of the UN. It has also initiated conversations with Libya concerning a possible future mission to assist with this country's border management.

Further east, in the Caucasus region and Central Asia, the EU launched the EUMM-Georgia and EUPOL-Afghanistan missions, both of which have been extended.

As previously mentioned, new missions have been undertaken in the Sahel region. These include EUCAP Sahel Niger, which provides civil capacity-building assistance and training; EU-AVSEC South Sudan, which is helping to improve security at South Sudan's Juba airport; the extended EUNAVFOR Somalia-Atalanta mission off the coast of the Indian Ocean, which combats piracy; EUTM-Somalia, which provides training for the Somali armed forces; and EUCAP NESTOR, which supports maritime capacity-building along the Horn of Africa and the Indian Ocean.

The implementation of a mission in Mali to support an African-led mission intended to pacify the north of the country was hindered by national interests, which – added to the reluctance of the Algerian and Malian governments and technical difficulties – delayed the Security Council's approval of these operations. The Security Council finally did approve a mission (AFISMA) that involved the deployment of a joint military force composed of troops from the Economic Community of West African States (ECOWAS). On 10 December the Council of Europe approved the crisis management concept for a new CSDP mission to provide military training and advice to the Malian army (EUTM Mali).

Difficulties in granting approval for the creation of an operations centre for support in the Horn of Africa once again brought to light the differing conceptions and aspirations of the countries involved regarding planning, command and implementation.

Two important crisis management exercises were carried out during 2012: the seventh Multi-layer exercise organised by the EU, which for the first time involved the different layers of EU response and management, from the political-strategic level to the operational level, and NATO's CMX12 exercise, in which the European External Action Service (EEAS) took an active part.

Institutional Operations

Denmark (which does not participate in the CSDP) held the presidency of the Council of the European Union for the first half of 2012, and Cyprus (which is not a member of NATO and has a low-profile defence policy) held the position for the second six months of the year. In response to the deepening financial crisis, priorities during both of these terms were centred on economic policy. The debate and conclusions at the Council meeting held in Brussels 28–29 June centred on economic and financial issues.

The conclusions of the 13–14 December meeting of the Council in Cyprus include a reference to the CSDP. After noting that the EU is being called upon to assume increased responsibilities in the maintenance of international peace and security, the Council reiterates the need to improve the CSDP and the responsibility of member states to provide future-oriented civilian and military capabilities. This document further stresses that, given present financial constraints, there is an urgent need to strengthen European cooperation in order to fill critical

gaps made manifest in the course of recent operations (Libya being one example) and invites the High Representative, through the European External Action Service, the European Defence Service and the Commission, acting in accordance with their respective responsibilities, to strengthen the CSDP in four main areas: effectiveness, visibility, military capacity-building and the capacity and competitiveness of the European defence industry.

In 2012, Patrick de Rousier (France) was appointed to a three-year term as president of the Military Committee. He replaces Hakan Syrén (Sweden).

The European Parliament's Subcommittee on Security and Defence held 17 sessions in 2012, which were devoted primarily to debates and agreements related to missions (the first few sessions focused on the Horn of Africa and the final sessions centred on the missions in the Western Sahel, especially the mission in Mali); the potential international Arms Trade Treaty; the implementation of the mutual defence and solidarity clauses contained in the Lisbon Treaty; Horizon 2020, the EU framework R+D programme for 2014–2020 and budget allotments for research related to security and defence; the EDA and pooling and sharing programmes; civil protection; and topics related to cyber security and satellites. In addition to these activities, debates were conducted and resolutions made on those sections of the High Representative's annual report on the ESDP related to the CSDP and a workshop was conducted on the situation in the Caucasus region.

The Debate on the Future of the EU and the CSDP

The economic crisis and concerns about the future of the euro and the Eurozone have given

rise to a series of debates that go beyond economic issues to include policy areas such as the CFSP and the CSDP.

Policy institutes and think tanks throughout Europe have been actively involved in this debate, which coincides with the tenth anniversary of the EUISS. This organisation, which is the repository of a decade of experience as an agency of the European Union, has become a key contributor of ideas and reports during this process. In 2012, the bulk of its activities and analysis were focused on topics related to the Asia Pacific and Indian Ocean regions, the evolution of situations in Arab Spring countries and the Sahel.

During the same period, the more than 20 centres belonging to the Common Security and Defence Policy Mission Analysis Partnership (CSDP-MAP), founded in 2008, have produced a large number of documents focused on the EU's present and future security and defence policies. Blogs that form a part of networks such as the Foreign Policy Association, which functions in English, and Bruxelles2, which functions in French, have also made a considerable contribution to the discourse.

One of the central themes articulated throughout these reflections is the need to define the EU's role as a global actor. At the 23 June meeting of the Foreign Affairs Council, four countries – Spain, Italy, Poland and Sweden – launched a wide-ranging project under the title »Towards a Global Strategy«. This initiative is being led by a quartet of think tanks (one from each of the organising countries), which have been joined by 16 additional institutions from other EU countries. Their goal is to produce a comprehensive report on the essential elements of a European global strategy to be presented in 2013.

Two other publications on the present state of the CSDP worth mentioning in this context

are the second edition of the updated *Handbook CSDP: the Common Security and Defence Policy of the EU*, edited by the Austrian Ministry of Defence, and *Military Capability Development in the Framework of the Common Security and Defence Policy*, edited by Jörg Hillmann and Constantinos C. Hadjisavvas and published by the Cyprus Presidency of the Council of the EU.

Final Reflections

For the past year, the priorities and actions of the EU and its member states have been centred on the economic crisis, its consequences and policies to overcome it. If, in addition to this situation, we add the fact that Denmark does not participate in the CSDP and Cyprus has a limited military capacity, it is not surprising that there have been few new initiatives or significant advances in this area. The Danish presidency opted not to address defence policy and the generic initiatives offered by the six-month Cypriot presidency have had very little overall effect on the CSDP. Based on the general priorities and agenda for defence outlined for the Irish presidency, which imply a continuation of those pursued throughout 2012, the first half of 2013 does not look very promising in this area either.

At the very time the EU holds the Nobel Prize in recognition of its contribution to lasting peace on the European continent and its role in progress towards peace throughout the world, it is failing to move forward in this area, one example being the delay in implementing important initiatives contemplated in the Lisbon Treaty, such as a permanent cooperation framework.

We have now arrived at a crossroads between the EU's historical role in world affairs

and its future as a player in a globalised world marked by the growth of new regional powerhouses and a shift of the centre of gravity on economic, political and security issues from the Atlantic and Western Eurasia to the Pacific and Eastern Eurasia.

The difficulty of identifying common core interests and the frequent intrusion of national interests have hindered the EU's efforts to craft clear and definitive common policies for foreign affairs, security and defence. Within this context, the CSDP, as an instrument of the Union's external affairs and security policies, can hardly be expected to make great steps forward: the means to implement a policy are only of use in scenarios in which there is consensus regarding where, when and how they will be used.

The differences between the requisites of the EU's role in civilian capacity building and those of the role it must assume in defence (above all military), both of which figure prominently in the policies that underpin the Union's presence in a diverse range of international scenarios, not to mention across-the-board budget cuts that have particularly affected defence expenditure, limited progress to technical advances throughout the past year. The main focus of 2012 was on efforts to develop pooling and sharing mechanisms.

This state of affairs allows for slow quantitative and technical improvement of the capacities the CSDP requires, although advancement is always contingent on the domestic circumstances of individual member states and the ever-present, dangerous temptation to renationalise – albeit only in certain areas – their security and defence policies.

The time has come to broaden citizens' awareness of how these policies affect the security they enjoy and the insecurities that concern

them on a daily basis and to strengthen the political leadership needed for common policies to take root and flourish. Only when this is accomplished will the EU's role as an authentic global

actor in every sense of the word be guaranteed and its capacity for action throughout the world be respected and admired by its international counterparts.

The Challenges of the EU in a Changing World

Niels Annen

Introduction

The historical facade remains mostly intact, but on the inside traditional foreign policy is undergoing profound changes. Revolutionary technological developments and subsequently an increasingly interconnected world have slowly undermined what was once the well-protected privilege of professional diplomats. Not only are cabinet ministers of all sorts managing their own foreign relations now, but private actors long ago started to trusted their own skills more than those of their governments to represent their interests abroad. The head of policy planning at the German foreign office, Thomas Bagger, observes a “diffusion of power”, while foreign policy actors are becoming more and more diverse.¹

Concentration, not diffusion of power was the idea behind the Lisbon Treaty’s set of rules to redefine European foreign and security policy that raised high expectations but, according

to most pundits, felt short. Whether justified or not, common wisdom among the press and foreign policy experts has it that the common security and defence policy (CSDP) has failed beyond recovery. Unfortunately, a less biased and fairer judgment has become the exception. There is, however, some progress to be reported: with the Political and Security Committee (PSC) the European Union has established an efficient and reliable instrument to provide in-depth analysis and advice and although the new European External Action Service is something of a hybrid – between a national and a European institution – its very existence is a sign of hope.

Nevertheless, the high expectations of Lisbon have not been met and the reason for this unsatisfactory situation is neither only to be found in the person of the High Representative nor in dire political circumstances. European foreign policy is facing multiple challenges simultaneously. What is true for national foreign offices – namely, that the nature of diplomacy and foreign relations is transforming the role of foreign ministries – is also posing a challenge to Euro-

¹ Thomas Bagger: Netzwerkpolitik, in: IP 1/2013.

pean diplomats and policymakers. To make things worse, the newly established EEAS still requires a great deal of attention, not to mention the daily challenge to streamline the foreign policies of 27 member states, which as such would be enough to deplete the resources of any High Representative, however ambitious. There are simply not enough resources and too little political credit to deal with these challenges adequately.

But the real challenge for CSDP right now is not the bureaucratic infighting in Brussels but the political consequences of the euro-crisis. Recent progress has been overshadowed not only by traditional European disunity over important dossiers but by neglect and marginalisation. The euro-crisis, it seems, has absorbed most of the attention and resources of European governments. In the face of staggering public deficits and severe austerity measures, foreign policy ranks low on the agenda of elected politicians. To most foreign ministers, taking a political risk to bring forward CSDP seems to be a bad bargain. This lack of leadership, however, comes with a price tag because the timing could not be worse. While new actors such as Brazil, India, Indonesia and other emerging economies claim their seats at the table of the rich and powerful, the European debate about how to react to the global shift seems to have ended before it even began. The year 2012 showed again that neither the revolutions in the Arab world nor the new American Pacific strategy have triggered a serious strategic debate outside the small circle of foreign policy pundits in Brussels, Berlin and Paris.²

² International Security Working Group, FES: "Presence with a Purpose" The Reorientation of US Security Policy, the Rise of China and Its Consequences for the Role of the United States in Europe, <http://library.fes.de/pdf-files/id/ipa/09332.pdf>

Strategic Partnerships

Given the changing international architecture, the need to reassess the existing foreign-policy toolkit seems to be more urgent than ever. One important tool has been the EU's approach to creating strategic partnerships with countries around the world. The European Security Strategy from 2003 mentions strategic partnerships as a goal and, ever since – the relations with the United States that were prior to the ESS being an exception – the Union has been in negotiations with several nations to prepare strategic partnership agreements. To date, the EU has signed agreements with Brazil, Canada, China, India, Japan, Mexico, Russia, South Africa, USA and South Korea.

But as Thomas Renard rightly remarks, it is not all that easy to find out about Europe's strategic partnerships, as there is no official document that lists them and other statements are sometimes confusing or even contradictory.³ From the very beginning of the EU's strategic partnership approach, critics lamented the lack of defining criteria for the chosen partners. A diplomat once famously explained how it feels to be a strategic partner of the EU: "It's like love – no one can define it. You only know what it is when you experience it."⁴

It thus comes as no surprise that it also remains unclear whether a strategic partnership, once signed, is in any way binding for the national policies of the member states. It is certainly also true that, not only within the framework of the common foreign and security policy,

³ Thomas Renard, *Strategy Wanted: The European Union and Strategic Partnerships*, <http://www.egmontinstitute.be/papers/10/sec-gov/SPB13-EU-Strategic-Partnerships.pdf>

⁴ EU Observer, 16.09.20120, <http://euobserver.com/institutional/30828>

the term “strategic” has been used in an inflationary way that has undermined the exceptional and compulsory nature that should characterise a real strategic partnership. Unfortunately, the EU’s High Representative, Catherine Ashton, has mentioned a couple of different countries as potential new strategic partners, such as Egypt, Israel, Indonesia, Pakistan, Ukraine and South Korea, adding to that confusion.

That is not to say that the entire process has been in vain. The process of formulating policy aims and the negotiations with a partner is helping not only to foster a relationship, but also to raise awareness of that very relationship within the EU. Strategic Partnerships are serving different purposes. They can help to improve the EU’s image and visibility abroad, as well as foster critical relationships with those states that are paramount for shaping international relations in the economic and political sphere. But as already mentioned, the criteria are not always clear and transparent. Why, for example, is Mexico invited to join the club but not Turkey? Some of the partners are obvious choices, such as the USA. But Europe’s partners are not all partners of choice. Although we do not always share common values, we have invested heavily in relations with our most important neighbour, Russia, a country that Europe simply cannot ignore. Other countries seemed to be less obvious choices. Renard distinguishes between essential partners (United States), pivotal partners (Russia, China, to a certain extent Brazil and India) and “natural allies”, such as Japan and Canada. Mexico and South Africa are categorised as regional partners.⁵ This categorisation makes clear that being a strategic partner does also not necessarily imply that

your country enjoys the same level of relationship – for example, a structured regular high-level dialogue – as other strategic partners. The term could easily lead to misinterpretations and false expectations among our partners, as well as in Europe itself, however.

It is of course crucial for the effectiveness of European foreign and security policy to entertain structured relationships with major actors such as the United States and China. But as Grevi⁶ mentions, partnerships with countries that are no major global players, but perform a lynchpin role between different groups or states are also of high importance for the EU and a laudable investment in the future.

With the looming crisis, bilateral relations – especially of the big players within the Union – have become more important. Europe’s financial calamities have reduced Europe’s leverage on the international stage and, as a consequence, the character of strategic partnership has been transformed over time. Europe is confronted with new powerful states that are no longer willing just to follow the lead of the United States and Europe and subscribe to the “one size fits all” economic advice of the Western-dominated Bretton Woods institutions. The dynamics of the G20, especially during the immediate response to the outbreak of the global financial crisis, illustrated that Europe’s strategic partnerships contributed little to increase the influence and effectiveness of European policies. This, to be fair, is also a structural problem because the EU as a non-member of the Bretton Woods institutions needs to leave this dossier to its members. European influence is thus limited

⁵ Renard, p. 2.

⁶ Giovanni Grevi, Mapping EU Strategic Partnerships, <http://www.google.com/search?q=FRIDE+mapping+EU&sourceid=ie7&rls=com.microsoft.de:IE-SearchBox&ie=&oe=>

and managed mostly through national governments.⁷

When the idea of strategic partnerships was developed, European diplomats had in mind to create an instrument that would provide them with an tool to gain privileged access to important countries, but also to “reward” certain countries’ progress in terms of strengthening democracy, guaranteeing human rights and pursuing a market-oriented policy. Today, the challenge for Europe is to deal with its strategic partners somehow in “reversed roles”, as they are seeking substantial contributions from their partners in fighting the crisis at home. Portugal is a case in point, as Lisbon has repeatedly turned to former colonies such as Brazil and Angola for help and for many especially young Portuguese citizens, looking for a job in Luanda or Maputo has become an attractive option to escape unemployment at home. Emerging economies have more than once indicated their interest in a quick and substantial recovery of the Eurozone. And countries such as China have made substantial investments in the euro and selected economies (China’s investment in Greek harbours being the most visible).

The EU Is Losing Ground

It seems that young people in Lisbon or Madrid have fewer problems adjusting to the new realities than some European bureaucracies. The challenge thus is not only to manage the crisis efficiently but to get along with the reduced bargaining position of the European Union, not an

⁷ Partners in Crisis: EU Strategic Partnership and the Global Economic Downturn, <http://www.frife.org/publication/1085/partners-in-crisis:-eu-strategic-partnerships-and-the-global-economic-downturn>

easy task for proud European negotiators who have got used to dealing with countries within the framework of development cooperation provided by Europe and the conviction that the success story of European integration would still serve as a role model for countries all around the globe. The reality today seems to be more prosaic. While the EU is losing ground in its trade share with countries such as India and Brazil, the loss of confidence in the ability to overcome the crisis is at least as severe and affects the attractiveness of the European Union as such. To be sure, it may hurt the feelings of Europeans to see the Republican candidate Mitt Romney bashing the EU for its supposed misguided policies,⁸ but the real cause for concern is the evaporating attractiveness of the EU’s integration model.

A brief look back in history makes clear that it has not been its military might – the EU’s accumulated military spending is higher than those of Russia and China combined⁹ – nor its skilled diplomats that laid the ground for its success, but the fact that for many countries the reconciliation and economic miracle of a continent once devastated by war and destruction made the EU an example to follow. The fact that European countries combined robust economic growth with the establishment of generous social welfare states made some observers dream of a political alternative to the deregulated capitalist economies in the Anglo-Saxon countries.¹⁰ Although this proved to be somewhat prema-

⁸ Thomas Kleine-Brockhoff and Peter Sparding: Crisis Talk: How the United States Discusses Europe’s Woes, http://www.gmfus.org/wp-content/blogs.dir/1/files_mf/1357313381KleineBrockhoff_Sparding_CrisisTalk_Jan13.pdf

⁹ See: <http://www.acus.org/natosource/eu-defense-spending-still-outstrips-russia-and-china-combined-little-show-it>

¹⁰ Steven Hill, *Europe’s Promise: Why the European Way Is the Best Hope in an Insecure Age*, Berkeley 2010.

ture, it is certainly true that the most important resource that European foreign policy had at its disposal was that very attractiveness. The prospect of becoming a member of the European Union motivated the people of Spain and Portugal to get rid of their right-wing dictatorships and cleared the way for profound economic reforms. Both countries became respected members of the Club and during the eastern enlargement, provided important advice, based on their own experience. Maybe even more important, without this “soft power” none of the regional conflicts that the EU helped to broker would have been resolved. The lack of military capabilities and the dysfunctional decision-making process during the wars in Yugoslavia is still a painful and vivid memory among European policymakers (“You cannot make war by committee”, as former Secretary of State Madeleine Albright candidly remarked). That is not to say that European military engagement was without relevance, bearing in mind that thousands of European soldiers are still on duty in the Balkans, but the lack of political unity and deployability of combat troops made Europeans rely on American support. The “European moment” came when it was time to make peace, however. One example of the effective use of soft power was the Balkan stability pact, proposed by then German foreign minister Joschka Fischer in 1999 at a foreign ministers’ meeting in Cologne that contributed much to ending the hostilities in Kosovo. The European Union offered what it could do best: help in stabilising the ailing economies, supporting the establishment of democracy and the guarantee of basic human rights, helping civil societies to develop and – maybe most important – offering a substantial upgrade of political relations. This offer was combined with a, however vague, option to become a member of

the European Union itself.¹¹ This offer has been perhaps the most effective foreign-policy tool of the Union ever since. It helped to stabilise the states of former Yugoslavia and served as an incentive to resolve territorial conflicts among candidate countries. Since the outbreak of the first Yugoslavia war in 1991 Slovenia has become a member of the Union and in July 2013 Croatia will follow suit. With the exception of Kosovo, which is not recognised as an independent state by all member countries, all the other states that once formed the Yugoslav Republic are today candidates or potential candidate-states with close relations with the EU. And although tensions remain, especially among Serbia and Kosovo, hostilities have ceased.

With the Copenhagen criteria for membership that candidates have to meet to become members, the EU established a transparent and rigorous instrument. To be sure, the European Union was not always as consistent in following its own criteria as it should have been – the unresolved conflict between the two parts of Cyprus being a case in point – but the overall balance is still remarkable.

Furthermore, the sometimes difficult management of the EU’s policies concerning its immediate neighbourhood benefits in large part from the ability to offer incentives such as closer economic cooperation, opening up of markets to association agreements and eventually membership, as we currently observe in the difficult case of Ukraine. Considering this experience in dealing with enlargement and neighbourhood policies, however, it is not surprising that the original concept of getting engaged in strategic partnerships rested in no small part on this capability to

¹¹ Florian Roth, *Deutschlands Rolle im Kosovo-Konflikt*, Nordstedt 2002.

integrate neighbours into a growing sphere of cooperation, peace and prosperity. With the latter gone, or at least threatened, European foreign and security policy finds itself at a crossroads because it not only has to face the traditional challenges in coordinating national policies and setting up an apparatus in spite of bureaucratic and political hurdles, but in addition it has to deal with the unprecedented situation that its major resource, attractiveness, is seriously endangered.

Under these circumstances, as Renard mentions, “the EU member states could actually see an opportunity for more cooperation rather than less, and invest in the EU’s capacity to become a true global strategic player”.¹² The reality, however, looks quite different. With almost all of the national governments preoccupied with management of the Eurozone crisis, little attention and resources are being spent on foreign and security policy. By no means the only, but still a relevant indicator of the state of Europe’s foreign policy are its defence expenditures. As Clara Marina O’Donnell from the Brookings Institution observes, “the majority of middle-sized EU countries have introduced military spending cuts of 10 to 15 percent on average. And several of the smaller EU member states have reduced their defence spending by more than 20 percent, leading to the loss of entire military capabilities. According to Andrew Dorman, although the United Kingdom has officially cut its defence budget by 7.5 percent over four years, in reality the reduction is nearly 25 percent.”¹³ This trend will, in the long run,

¹² Renard, p. 5.

¹³ Clara Marina O’Donnell, *The Implications of Military Spending Cuts for NATO’s Largest Members*, The Brookings Institution, Washington DC 2012, http://www.brookings.edu/~media/Research/Files/Papers/2012/7/military%20spending%20nato%20odonnell/military%20spending%20nato%20odonnell%20pdf.pdf?_lang=en

endanger the goal of a common security policy that the Union approved at its summit in Cologne.¹⁴ Especially striking, it seems to me, is the almost complete failure to take into consideration the strategic implications of national policy decisions concerning foreign and security policy. Even if the current fiscal needs of member states would make it unavoidable to cut spending for foreign services, development aid and military spending, a minimum of coordination and pooling and sharing could have ameliorated the consequences for reduced deployability and the credibility of Europe’s foreign policy. Another underrated aspect of this development is that Europe’s weight within NATO is further shrinking. As a consequence, the ratio of the alliance itself will be affected, providing a pretext for those political forces within the United States that have long advocated unilateral action. For a Union that officially states that the United States is its “foremost strategic partner”, the continued failures in strengthening a common security policy make the well-sounding declaration of the EU Security Strategy – “the transatlantic relationship is irreplaceable. Acting together, the European Union and the United States can be a formidable force for good in the world ” – sound hollow.

A New Role for Germany?

Given the deficiencies and crisis of confidence of the European Union, it is not surprising that for some partners of the EU it is tempting to work directly with the most important countries. This is especially true for Germany, Eu-

¹⁴ International Security Working Group, *FES: A Compass for the CSDP*, Berlin 2012, <http://library.fes.de/pdf-files/id/ipa/08998.pdf>

rope's biggest economic power. It is by no means self-aggrandising to say that today no basic political decision within the EU can be made without the consent of Berlin. For German policymakers this development represents a daunting challenge. Since the establishment of the Federal Republic in 1949 it has been the bipartisan foreign policy consensus that Germany should never again go its own way. Positioned in the heart of Europe it has always been the German dilemma that the country has been too powerful to be ignored, but never powerful enough to dominate the continent. Germany's interest should therefore be pursued as an integral part of its neighbours. Former Chancellor Helmut Schmidt reminded his listeners at his Social Democratic Party's national convention in Berlin 2011 that "If we Germans were to be tempted by our economic strength into claiming a leading political role in Europe or at least playing the role of first among equals, an increasing majority of our neighbours would mount effective resistance. The concern among the states on the periphery about the centre of Europe becoming too strong would return very quickly. The likely consequences of such a development would cripple the EU and Germany would lapse into isolation."¹⁵

Helmut Schmidt's words still carry a lot of weight in the country he once governed, but the political circumstances are much more complex today than during the Cold War, when West Germany could hide its weight behind its allies. The fact that Germany is today the only major power in Europe that does not seem to have lost its ability to act limited by the euro crisis has made the country a reluctant leader, a

position it is obviously not prepared to fulfil. On one hand, German elites are still committed to the basics of the consensus Helmut Schmidt defended so vigorously, while on the other hand, if one listens carefully to the debates in Berlin discussions about a new German hegemony are, albeit carefully and cautiously, under way.¹⁶ The official Berlin line stresses continuity, but the harsh conditionality of Chancellor Merkel's policies says otherwise. While Germany's austerity policies are already slowly damaging the overall positive image of the country, especially in the crisis-striven South of Europe, German foreign policy, in sharp contrast, remains erratic at best. The obvious contradiction between Merkel's surprisingly evenhanded use of economic power during the crisis and Germany's reluctance to play a leading role in foreign policy – the German abstention in the Libya case is by no means forgotten among Germany's allies – make it difficult to predict the country's future path. Although warnings that Germany could soon be tempted to leave the Eurozone and attempt its own strategy as a "BRIC" are grossly exaggerated,¹⁷ it is obvious that there is a certain temptation in Berlin to use its current leverage for its own economic advantage. Germany has been very successful recently in strengthening its bilateral relationships with important actors such as China and India. With the continuation of Euro crisis, the intensity of these relationships has further intensified. Official consultations between the governments of Germany and its counterparts in China and India often include major cabinet ministers from both

¹⁵ Helmut Schmidt, *Germany in and with and for Europe*, http://www.feps-europe.eu/en/news/275_germany-in-and-with-and-for-europe

¹⁶ Christoph Schönberger, *Hegemon wider Willen? Zur Stellung Deutschlands in der Europäischen Union*, *Merkur* I, 2012

¹⁷ Wolfgang Münchau, *Financial Times*, 5.2.2012, <http://www.ft.com/intl/cms/s/0/63336a04-4e65-11e1-aa0b-00144feabdc0.html#axzz2HzQPHISx>

sides, underlining the importance of the relationship. The role of the EU's strategic partnership strategy remains unclear in Germany's approach. Whether intentionally or not, German policies are playing into the hands of countries such as China, circumventing Brussels and managing their relations directly in bilateral negotiations with "the big guys".

Conclusion

The flaws of Europe's strategic partnership programme are well known and obvious. The lack of criteria, the unclear and sometimes vague and non-binding outcome of the partnership and the unsolved problems of overlapping European and national policies are examples of the problems that the European foreign and security policy is facing today. Nevertheless, investing in bilateral relations with important global actors makes a lot of sense and is a reflection of the rapidly changing international scene. Given the dramatic changes, a structured dialogue with strategic partners has perhaps never been as necessary as today. Over the past few decades, the Western-dominated liberal international order has provided a successful framework for economic growth and stability and maintained its attractiveness, as it still seems to be "easy to join and hard to overturn".¹⁸ But it is without doubt also an order that has been built by Western powers and primarily serves their interests. Countries such as Brazil, India and China have benefitted from playing by the Western rules, but as they become stronger, it seems only logical that they try to adjust the

current system and make it more responsive to the demands of Brasilia, Delhi or Beijing. If Europeans adapt to the new realities and accept a partnership at eye level, the EU can make a substantial contribution in modelling the new order, especially when the Western countries accept that not everything can stay as it was. In particular the policies of institutions as the IMF and the World Bank under the current neoliberal hegemony have triggered justified criticism from developing countries.

Although we can find little proof so far, there is of course the possibility that countries such as China in the long run are not seeking to adjust but to change the current international order. Europe should, however, resist the temptation to once more think in terms of a binary logic and distinguish between friend and foe.¹⁹ It is therefore promising that most of the strategic partnership agreements that have been signed in recent years have included emerging economies such as Brazil, but also regional actors such as South Africa and Mexico. And it was the right decision not to exclude countries such as Russia and China from becoming a strategic partner, even though we might not agree with their domestic order and lack of democratic rights.

Europe's Strategic Partnerships are not an expression of a grand strategy in foreign policy. They are better described as a flexible instrument in the EU's toolbox. In order to make them more efficient, the EU would have to set up clearer priorities or, as Catherine Ashton puts it: "fewer priorities, greater coherence and more

¹⁸ See: http://www.stanleyfoundation.org/globalleadership/2012_Princeton_Global_Governance_Conference_Meeting_Note.pdf

¹⁹ See Dan Kliman, Richard Fontain, Global Swing States, Brazil, India, Indonesia, Turkey and the future of the international order, http://www.gmfus.org/wp-content/blogs.dir/1/files_mf/1353953219CNAS_GlobalSwingStates_KliManFontaine.pdf

results".²⁰ In recent years, several recommendations to improve the EU's track record have been published and some helpful advice has been given. The shortcomings of CSDP, however, cannot be solved within the bureaucracy in Brussels, although there is of course room for improvement. National governments will have to reassess their own foreign policy approach and to decide whether or not they will use the platform the EU provides to pursue their policies and rely on their own bilateral networks. As Stefan Lehne observes, the effectiveness of European foreign policy depends in large part on the behaviour of the "big three": the United Kingdom, France and Germany, all of whom can rely on their own weight and influence and thus do not necessarily rely on the EU to pursue their interests.²¹ And as the decision of French President Hollande to intervene in Mali showed, France and the United Kingdom in accordance with their respective traditions as colonial and military powers have few reservations in using that privileged position if deemed necessary. For many, especially smaller member states, however, there is no such choice; the success of the entire CSDP will thus largely depend on how the big countries take their decisions. Right now, all eyes are on Germany, but Berlin would be ill advised to overestimate its current economic strength as eternal.

Traditional foreign policy is changing; traditional diplomacy remains important but diplomatic elites long ago lost their exclusive privilege to determine a nation's foreign affairs and a variety of state and non-state actors today dominate the scene. To set policy priorities will thus be the major challenge for decision-makers. A clearly structured partnership programme can help to master these challenges, but foreign policy will remain strongly determined by reactions to current events.

If European politicians follow Mrs Ashton's advice to set fewer priorities it is worthwhile not only to think about the "new kids on the block". With a shrinking population and a severe economic and political crisis, Europe should not underestimate the importance of its traditional alliances, especially with the United States. So far there has been little to no strategic debate about the consequences of President Obama's new Pacific strategy and what challenges this poses for Europe. Despite all the talk about the decay of Europe and the decline of US power, both partners will remain relevant for the foreseeable future. But they will perhaps never again be alone at the table when the important decisions are made. I believe this should be a strong reason for the revitalisation of a real strategic partnership.

²⁰ Quote in Giovanni Grevi: Why EU strategic partnerships matter, ESP working paper 1, <http://www.frife.org/publication/1031/why-eu-strategic-partnerships-matter>

²¹ Stefan Lehne, The Big Three in EU Foreign Policy, <http://carnegieendowment.org/2012/07/05/big-three-in-eu-foreign-policy/ck4c>

The European Neighbourhood Policy: A Policy for the EU's Southern and Eastern Neighbours

José Manuel Albares, Carlos Carnero

The European Neighbourhood Policy, launched in 2004, is an EU initiative designed to strengthen the Union's relations with its southern and eastern neighbour states by fostering their stability, prosperity and border security. It is directed towards the 16 countries that flank the EU's southern and eastern borders, including those situated in the Middle East. The evolution of this policy during 2012 was based on orientation provided by reports issued by the European Commission and the European Parliament and, to a certain extent, driven by events along the Union's southern border collectively referred as the "Arab Spring".

Both the Commission and the Parliament articulated the importance of strengthening relations with ENP states in their 2011 reports, stressing the need to infuse the EU's neighbourhood policy with new approaches and solutions that take into account the constant change that

is occurring in these countries. A changing neighbourhood calls for a new approach geared towards promoting deeply rooted and sustainable democracies along Europe's borders.

Indicative budgets have been prepared for various periods. The budget for 2001–2013 has been set at 5,700 million euros, although a subsequent review has established that an additional 1,242 million euros would be required to fully implement the policies outlined.

A 18,182.3 million euro indicative budget has been established for the period 2014–2020, although given the current economic situation in the EU, one must assume that fewer resources will be available in the future. How the European Neighbourhood Policy evolves will depend upon the regulation of financial provisions, a factor on which external actions are especially contingent.

The European Neighbourhood Policy for the Mediterranean

The southern Mediterranean countries covered by the ENP are all members of the Union for the Mediterranean (UfM): Algeria, Egypt, Morocco, Libya, Tunisia, the Palestinian Authority, Albania, Jordan, Israel, Lebanon, Syria and Turkey.

During 2012, policy for Southern ENP countries continued to undergo the reorientation initiated in 2010 in response to revolutionary movements that emerged in Maghreb countries and gave rise to what has come to be known as the “Arab Spring”. The Arab Spring revolutions not only radically transformed the political scenarios of southern ENP states, but – due to the tolerance and, at times, the complicity of many member States with political regimes in the region – also left the European Union, as a political entity, in a difficult position. In the wake of these events, the European Union has actively fostered close cooperation with these countries with a view to easing their transitions to democracy. The assistance offered to Egypt and Tunisia under the “Partnership for Democracy and Shared Prosperity” initiative is a concrete demonstration of the European Union’s commitment to the democratic transformation of these states and a model for future partnerships with other Southern Mediterranean countries.

In May 2011, the Commission and the High Representative for Foreign Affairs and Security Policy issued a joint communication on the review of European Neighbourhood Policy under the title “*A New Response to a Changing Neighbourhood*”. The activities outlined for this initiative, which were partially implemented in 2012, are geared towards three principal goals: (1) *democratic transformation and institution building*; (2) *the strengthening of civil society and*

human rights and freedoms; and (3) *sustainable and inclusive economic development*.

On the basis of their progress in key areas such as economic and social reforms, countries can become eligible for “advanced status”,¹ which will put them on track to enter into a “Partnership for Democracy and Shared Prosperity”.

The long-term goal of these incentives is that participating southern ENP countries that make sufficient progress will be able to forge closer political associations with the EU and be integrated into the EU Internal Market, although unlike their Eastern counterparts covered by the European Neighbourhood Policy, they would *never* be considered as potential members of the European Union.

In 2012, policy engagement was strongest with Egypt, Tunisia, Syria and Libya.

Egypt: The most important event in UE–Egyptian relations during 2012 was the meeting of the EU–Egypt Task Force, held in Cairo, 13–14 November. This encounter was co-chaired by EU High Representative Catherine Ashton and Egyptian Foreign Minister Kamel Amr. The task force represents a new form of European diplomacy conceived to further EU engagement with countries in transition through the mobilisation of all EU assets and working contacts with both the public and the private sector. The event brought together more than 500 participants committed to launching a new working relationship between the EU and Egypt. EU participants included representatives of the EEAS, the European Parliament and Commission, the EIB, the EBRD and various Member States, as well as leaders of the business community. During the two-day meeting, participants discussed a wide

¹ Morocco in 2008 and Jordan in 2010.

range of issues including economic cooperation, commercial ties, asset recovery, political reform, governance, human rights, infrastructure, ICT and science.

The European Commission made a commitment to provide a total of nearly 800 million euros in additional financial support to Egypt: 303 million euros in the form of grants and a further 450 million euros in loans. These figures do not take into account the 449 million euros already allocated by the EU for Egypt for the period 2011–2013. The president of the EIB also announced potential lending of up to 1 billion euros per year and a fund that can provide up to 60 million euros for countries in transition. The EBRD confirmed the start of operations within a month of the meeting and announced plans to increase annual lending volumes to 1 billion euros, as well as a new food security initiative financed by a combination of official funding and private sector investment. The EU has become Egypt's main trading partner; it is currently responsible for 80 per cent of this country's foreign investment.

Three agreements related to SMEs in rural areas, the extension of the Cairo metro system and measures to boost trade were also signed by the EU and Egypt during this meeting.

Tunisia: Cooperation between the EU and Tunisia has advanced dramatically since 2011 on a number of fronts. In 2012, a civil society support programme was initiated, a regional and local development programme that addressed health issues was launched and a programme for supporting economic development and administrative reforms was created. The EU Partnership for Peace programme was also rolled out on 17 December 2012.

Syria: Throughout 2012 the European Union implemented restrictive measures against Syria in an effort to increase pressure on the

government of President Bashar al-Assad. From the outbreak of the crisis through the end of 2012, a total of 19 sets of restrictive measures were introduced and these were reinforced on seven occasions (January, February, March, April, May, June and October). In July, the EU strongly condemned incursions and other incidents that occurred along the Syrian–Lebanese border and it issued another condemnation in October regarding the shelling of Turkish territory by Syrian forces, during which many civilians were injured or killed. The EU has also consistently called for al-Assad to step down and make way for a peaceful transition in accordance with the lines of action adopted by the League of Arab States.

As a whole, the EU has committed more than 321 million euros in humanitarian assistance and other forms of aid to Syrians inside and outside their country and is the largest donor of aid related to the Syrian crisis.

Libya: To assist in Libya's transition to democracy, the European Union, together with the United Nations and other international partners, engaged in extension discussions with the Libyan authorities regarding the country's priorities. One of these key priorities was border management. In late February, the EU deployed an expert mission to assess the country's needs in this area. A team of experts drawn from 10 member states carried out a three-month mission designed not only to help the Libyan authorities assess the country's border management needs but also to develop recommendations to the EU on medium- to long-term support and early concrete action that would help Libya to ensure the secure and effective management of its air, maritime and land borders. This assessment is part of a wider programme of support for Libya worked out with the Libyan authorities that included *humanitarian assistance* provided during

the crisis and a *30 million euro aid package* designed to help Libya deal with its most urgent problems.

Democracy and Human Rights

Regarding the rule of law and human rights (centred in the core concept of “*deep democracy*”), three distinct types of action have been identified as essential: the first concerns support for citizens’ rights and freedoms and focuses on governmental respect for fundamental rights and freedoms, the empowerment of women, religious freedom and freedom of the press; the second focuses on the strengthening of institutions and entails capacity-building (particularly in the sphere of government) and public administration reform; and the third involves political cooperation in a number of different areas.

In defence of human rights and freedoms, the European Union has publically condemned acts perpetrated by authoritarian regimes against their citizens and has responded to such situations by suspending bilateral negotiations and cooperation programmes with these countries. This line of action, the prime example of which was the EU’s response to the Kaddafi regime in Libya – which included the implementation of highly specific sanctions such as the embargo of equipment and supplies that could be used for suppression of the country’s population – has also been applied to Syria, although its implementation has been slower and at times subject to vacillation.

The European Union has also sporadically pursued other types of initiative in the region related to issues such as the social inclusion of women or the effective enforcement of the right of religious freedom, especially for these countries’ minority communities. Support has

been provided through the Commission for the free circulation of information; guarantees that ensure that journalists are able to carry out their work independently without political, economic, or other pressures; and the building of infrastructure required to develop modern technologies.

Throughout 2012, the European Union also continued to provide support for capacity-building, putting strong emphasis on strengthening government institutions that are key to ensuring the consolidation of the democratisation now under way.

Finally, it is worth mentioning a few of the most important actions related to political reform that have been carried out by the European Union with an eye to improving governance and raising the standards of respect for human rights in these countries, such as support provided to national commissions for constitutional reform and elections and election observation missions. The latter constitute an essential element of the European Instrument for Democracy and Human Rights (EIDHR), through their presence during elections held in Tunisia in 2011 and Libya and Algeria in 2012.

Economic Prosperity

The European Union has used its instruments and institutions, as well as political dialogue and cooperation to reach agreements related to free trade, financing and economic aid.

This has entailed upgrading free trade agreements already in place with all the countries in the region, except Syria and Libya. Among other things, these agreements allow the free flow of industrial products from one participating market to another. They have also paved the way for preferential treatment of agricultural and

fishery products, especially those from Egypt and Jordan.

Regarding aid, it is worth noting that as of the beginning of 2013, the European Union had provided 4 billion euros in funding, the bulk of it channelled through bilateral assistance programmes. Humanitarian aid to the region, for example, has reached the 30 million euro mark and Tunisia has received 17 million for its transition to democracy. Funds are also provided by the EIB, which has been active in the region for more than 30 years and currently works through FEMIP.

The European Parliament has urged the Commission to approve a legislative proposal that would permit financial intermediaries to reinvest funds from previous programmes in the private sector. It is forecast that this reformulation could generate approximately 200 million euros in 2013.

The possibility of using EU macro-financial assistance as a mechanism to help countries with association agreements cope with short-term balance of payments problems has also been contemplated.

In terms of political dialogue and cooperation, particularly notable are the current dialogue on macroeconomic governance and budgetary sustainability, focused on a study of key structural reforms, the role of small- and medium-sized enterprises in the creation of employment and the need of a corresponding regulatory framework.

The Commission has worked to boost industrial cooperation at the Euro-Mediterranean level in a number of ways: it has advocated the implementation of the Euro-Mediterranean Charter and sought to bring the aspects of that document that were pertinent to SMEs in line with the EU's Small Business Act for Europe; pushed for the implementation of common best

practices; and promoted activities and networks in priority sectors.

Civil Society

Given the ramifications of the Arab Spring, civil society has become a key element in the revised EU neighbourhood policy. Therefore, the Commission is attempting to launch a dialogue on matters such as migration,² mobility and security. This would be an important step to a Mobility Partnership for countries such as Morocco, Tunisia and Egypt. New initiatives have also been launched to strengthen European support for civil society organisations and assistance in developing a platform for civil society groups, political parties, trade unions and business and professional organisations.

Outstanding examples of the EU's spirit of cooperation and neighbourhood engagement that have involved substantial financial commitments are worth noting. Tunisia, for instance, was the beneficiary of a 2 million euro package to promote political reform, electoral processes and the independence of civil society and the media, provided through the EU's Instrument for Stability, as well as an additional 1.2 million provided through the Union's Development Cooperation Instrument for a "non-state agent and local authorities" programme. In the case of Libya, the EU mobilised nothing less than 70 million euros in humanitarian aid to deal with the consequences of the civil war and assist refugees and displaced persons and also provided 5 million euros to finance the repatriation

² These proposals are articulated in detail in the Communication "A dialogue on migration, mobility and security with the southern Mediterranean countries", COM (2011) 292, pg. 3.

of third-country nationals through the European Civil Protection Mechanism.

It should be kept in mind that all ENP actions are derived from specific *Action Plans* that provide the general framework for any cooperation initiative. Action Plans are worked out jointly by the European Union and the beneficiary to guarantee that each one is tailor-made to suit the needs and interests of the country in question, although all lines of action and conditions are set by the EU. They are therefore, as previously noted, based on criteria of differentiation.

Just as the *Union for the Mediterranean* (UfM) provides southern ENP countries with an essential permanent forum for dialogue and cooperation, it also serves the European Union as an auxiliary means of promoting democracy to partners with whom it maintains bilateral relations.³ The UfM should assume the role of ensuring that regional cooperation is inclusive and works towards the integration of candidates for future membership in the EU, such as Turkey and the Balkan countries. It has its own parliamentary assembly (AP-UfM), even though this body functions as a purely consultative body without legislative powers. In view of the UfM's institutional paralysis and meagre past performance, efforts were made in 2012 to improve its operability and effectiveness.

Last year the Commission announced a reformulation of the Union for the Mediterranean with an eye to transforming it into an entity capable of acting as a catalyst for initiatives undertaken by states, international financial institu-

tions and the private sector to boost employment, innovation and growth in the region. The UfM has yet to exploit its potential for organising effective, results-oriented cooperation initiatives, an endeavour that would entail a shift towards a more pragmatic approach focused on projects. However, time could be running out for the UfM, which so far has succeeded only in generating the scepticism of governments and citizens.

The objective of the UfM and the various instruments previously referred to is, when all is said and done, to articulate a *partnership for democracy and shared prosperity* based on a solid track record of progress towards democracy, human rights, social justice, good governance and the rule of law.

It is important to note that the European Parliament's delegation to the Euro-Mediterranean Parliamentary Assembly – whose next meeting is scheduled to take place in Strasbourg in January 2013 – is active and well-structured and that the mandate of the Special Representative for the Southern Mediterranean appointed by the European Union in 2011 has been renewed.

The European Neighbourhood Policy for Eastern European Countries

The European Neighbourhood Policy was developed in the wake of the major amplification of the EU undertaken in 2004 as a means of responding to neighbour states situated along the Union's newly expanded eastern border. Subsequent amplifications and the extension of the ENP to include the neighbours to the south have supposed modifications to the original policy, and in 2012, the territory it covers was extended to include Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine.

³ The Mediterranean neighbour states that are currently members of the UfM are Algeria, Egypt, Morocco, the Palestinian Authority, Tunisia, Albania, Israel, Jordan, Lebanon, Mauritania, Syria and Turkey. Libya participates as an observer.

There was a significant level of activity related to the European Neighbourhood Policy during 2012. One milestone was “Delivering on a new European Neighbourhood Policy”, a new joint communication issued by the European Commission and the High Representative of the European Union for Foreign Affairs and Security Policy that fleshed out the dynamics of a new “more for more” approach introduced one year previously in the 25 May 2011 communication “A New Response to a Changing Neighbourhood”. The 2011 document was drafted as a response to the Arab Spring. Nevertheless, in practical terms, the policy has generated more positive outcomes in eastern countries than in southern countries. ENP progress is gauged by a country’s acceptance of the EU’s *acquis communautaire*; eastern states such as Moldova are in a better position to adopt the *acquis* and therefore to reap the economic, political and social benefits that closer approximation to the EU implies.

Progress reports for 2011 on Armenia, Azerbaijan, Georgia, Moldova and Ukraine (the dictatorial regime under Lukashenko impedes Belarus’s full participation in the ENP programmes) attest to the advances made in countries along the EU’s eastern border. The introduction of the Eastern Partnership Integration and Cooperation programme (EaPIC) in 2012, which was backed by the European Commission, also paved the way for future advances.

The following are short overviews of the progress made by Eastern Partnership countries during 2012:

Moldova: Moldova can be commended for the progress it has made on neighbourhood issues and its level of approximation to the *acquis communautaire*. It stands out as the country that has made the greatest strides toward this objective. In response, the EU has increased its

financial aid to this country by 94 million euros as part of its 2012 Action Plan and has gone forward with negotiations toward a Deep and Comprehensive Free Trade Area agreement. Nevertheless, the observations of the European Delegation in Chisinau regarding the growing intolerance towards certain minorities – homosexuals and transsexuals in particular – has raised concerns that a greater effort needs to be made in this area.

Ukraine: This country has experienced setbacks that have slowed its process of integration and hinder closer ties to the EU. Recent stumbling blocks in EU–Belarus relations include the arbitrary sentencing of the country’s former interior minister Yuriy Lutsenko and widespread concern caused by the precarious situation of the imprisoned former premier minister Yulia Tymoshenko. Troubling irregularities in parliamentary elections held at the end of October 2012, such as a failure to conduct a full tabulation of votes cast and a lack of transparency in campaign financing, have drawn heavy criticism from EU institutions.

Belarus: Continual violations of human rights and liberties committed by the Lukashenko regime have led to tense relations between the European Union and this country. A government crackdown on opposition parties and irregularities in parliamentary elections held in Belarus in September 2012 have led to an even higher level of tensions between Minsk and Brussels over the past few months. In response to these abuses, the European Council decided to prolong the current restrictive measures imposed on Belarus through 31 October 2013.

Southern Caucasian countries:

Georgia: This country has managed to conduct open and transparent elections and effect a peaceful and democratic transfer of power. The winner of the most recent elections was

Bidzina Ivanishvili, one of the country's most wealthy businessmen. This demonstration of respect for democratic processes signifies a giant step forward in the country's approximation to European standards of governance. The election also paves the way for Georgia to normalise relations with Russia, an important pending issue on the country's agenda. In view of these events, the European Union has extended its monitoring mission in Georgia to September 2014, which has been allotted a budget of 20.9 million euros, and continues negotiations with Georgia regarding the development of a Deep and Comprehensive Free Trade Area.

Armenia: The EU's relations with Armenia have strengthened over the past year. Negotiations have been undertaken concerning market liberalisation and steady progress has been made towards an Association Agreement.

Azerbaijan: Certain practices that run counter to European values, such as the unwarranted detention of journalist Idrak Abbasov, have marred the image of Armenia's neighbour Azerbaijan. On the other hand, the Azerbaijani government's decision to release political prisoners was well received by authorities in Brussels. The High Representative for Foreign Affairs and Security responded to the recent rash of violent incidents between Armenia and Azerbaijan over the Nagorno-Karabakh region, calling on both parties to respect the ceasefire and work with the OSCE towards a peaceful solution to the ongoing stalemate.

Democracy and Human Rights

Various measures providing support for reform of political structures have been undertaken in this area, such as the creation of High Level EU Advisory Groups in Armenia and Moldova. The

European High Representative for Foreign Affairs and Security has recommended that the Commission extend similar assistance to all the other Eastern Partnership countries as well.

There have also been efforts to engage civil society in this region. To this end, 22 million euros have been earmarked for the creation of a civil society facility to promote change and democratisation, which has been designed to be compatible with the existing European Instrument for Democracy and Human Rights (EIDHR).⁴

In terms of political events, 2012 has been marked by electoral processes throughout this region. Elections were held in Georgia last October. Since April 2012, Georgia has asked the European Council and Parliament for assistance and requested the presence of international election observers to ensure the transparency of its upcoming elections. It also appealed to the European Union to coordinate and monitor media coverage of the campaign and elections. The EU and the UNDP were largely responsible for the organisation and financing of these activities. Approximately 700 OSCE observers were on hand to monitor elections held in Ukraine on 28 October in the tense shadow of the Timoshenko situation.

Economic Prosperity

The EU has maintained a series of funds earmarked for development and economic ties between the Union and its neighbourhood partners. One of its better-known instruments is its cross-border action policy, which comprises a range of implementation models and action

⁴ PE (2011) p. 4, 14.12.2011

plans designed to further the key objectives of promoting economic and social development in the border areas, working together to address common challenges, ensuring efficient and safe borders, and promoting local “people-to-people” cooperation.

In terms of financing, a budget of 950 million euros has been established to cover the 13 programmes scheduled for the period 2007–2013. This initiative has also received financial support from the European Regional Development Fund.

Issues related to trade are addressed by means of partnership agreements worked out under the Deep and Comprehensive Free Trade Area (DCFTA) framework and through Association Agreement (AA) negotiations. Ukraine was the first state to enter into these negotiations, followed by Georgia and Moldova in early 2012. DCFTA's main objectives are promoting reciprocal trade by raising existing barriers and introducing EU norms and standards in third party countries.

2012 was also a strong year for the development of flagship initiatives focused on integrated border management, projects directed towards small- and medium-sized enterprises; projects centred on regional electricity markets, energy efficiency and sources of renewable energy; natural disaster prevention, preparation and response and environmental governance programmes.

Civil Society

The EU has deployed a number of instruments to address a wide variety of civil society issues. The most significant initiatives have been in the areas of:

- Territorial mobility (Visa Code).⁵ The liberalisation of visa and border crossing procedures is intended to facilitate the mobility of citizens of ENP countries within the EU and between ENP states. The process entails a range of activities, beginning with the planning and implementation support that the EU provides for the liberalisation of visa procedures in Eastern neighbourhood states that is needed to forge advanced accords in the future. Significant assistance in this area is currently being provided to Ukraine and Moldova.
- Cooperation on justice, freedom and security. During its second ordinary session held 3–4 April 2012 in Baku, Euronest, a parliamentary forum that promotes integration between the European Union and its Eastern European partners, developed resolutions on challenges for the future of democracy, trade agreements between the EU and its Eastern European Partners and EU assistance in this field, energy security and renewable energy, the strengthening of civil society and the situation of Yulia Tymoshenko.

The Outlook for 2013

The new European Neighbourhood Policy launched in 2012 is a set of strategies and lines of action not necessarily bound to a global vision for the 16 states that flank the eastern and southern borders of the EU, some of which are Middle Eastern countries.

At the moment the various Arab Springs caught fire, the ENP, which had already been in place for some time, was poised for a major

⁵ COM (2011) p. 12, 25.5.2011

overhaul. The popular manifestations of frustration with the political status quo in many Arab countries highlighted the ENP's limitations as a vehicle for decisive and effective EU intervention in its immediate neighbourhood and the urgent need to reformulate its policy in this area.

Notwithstanding this, efforts to renew this policy have been centred mainly on budget increases for ENP 2011–2013 (an additional 1 billion euros that brought the total budget to 6.9 billion) rather than a rethinking of the policy itself.

For example, no commensurate effect has been made to give the ENP a comprehensive approach that would foster interregional cooperation. At present, policy is handled on a country-by-country basis.

Likewise, the ENP continues to be essentially centred in economic issues and gives short shrift to diplomatic and security issues.

Furthermore, the fact that this policy is managed exclusively by the Commission gives rise to a certain level of self-absorption centred on the bilateral relations between Brussels and individual neighbourhood states, which translates into a reticence to build critical synergies with other actors that are increasingly engaging in both regions, such as Turkey and the United States.

Finally, the response that the ENP purported to offer in 2012, above all to the neighbour countries to the south, was based in the premise of significant advances toward democratisation, a condition that varied considerably from one country to another.

To add to this difficulty, the three Ms (money, markets and mobility) that constitute the EU's main lines of action in response to the Arab Spring have been severely affected by the continuous deepening of the crisis that has marked the entire year.

Budget reductions and the protagonism of national politics in the agendas of many EU

member states have meant that the outcomes of this three-prong strategy have fallen short of expectations.

In spite of the reformulation that it has undergone, the European Neighbourhood Policy has been carried forward into 2013 hindered by the same difficulties that its predecessor struggled with, and there are few indications that things will improve in the short-term.

The complete work of updating the NEP to reflect the new situations in neighbour countries – especially those on its southern frontier – remains a pending assignment.

In any event, it is clear that steps must be taken to strengthen the ENP. In the spirit of bettering this programme, we offer the following *recommendations for 2013*:

- Maintain or increase both short- and long-term budget commitments, including those contained in the multiannual financial framework set out for the period 2014–2020;
- Adhere to the practical application of the core, fundamental ideas behind the ENP: the development of full-fledged democratic systems and comprehensive free trade areas;
- Turn words into action regarding the three Ms: money, markets and mobility;
- Continue prioritising the strengthening of civil society;
- Strengthen parliamentary support programmes;
- Create an atmosphere of greater transparency and fluid communication regarding the dialogue, agreements and programmes undertaken through the European Neighbourhood Policy;
- Adopt an approach that differentiates between the EU's southern and eastern neighbourhoods and acknowledges their diverse circumstances rather than assuming uniformity between them;

- Put the UfM on a definitive solid footing;
- Provide continuous support for regional projects and ensure that they are not abandoned in favour of bilateral action plans;
- Coordinate actions carried out in ENP countries with international partners such as the United States.

Recommendations

Recommendations

European Affairs Council of the Fundación Alternativas

To conclude this 2012 Report on the State of the European Union we offer a number of recommendations, as discussed by the European Affairs Council of the Fundación Alternativas.¹

The recommendations, intended to be brief and clear, are structured around six key political priorities that, in our view, need to be addressed by the European Union (EU) from 2013, namely, ending the crisis, economic integration, the European social model, the EU as a global player, deepening democracy and constitutional reforms.

The rate of implementation of the recommendations will be affected by the political and economic situation, the results of the European elections, the political will of governments and the momentum provided by citizens. However, we understand their implementation to be a necessary part of the European project, if the EU is to progress and be strengthened.

Ending the Crisis

1. EU economic policy needs to turn towards economic growth and job creation, given the abject failure of austerity policies and budget cuts. The adoption of economic stimulus measures is a matter of great urgency, especially in countries with more balanced macroeconomic indicators.

¹ The European Affairs Council of the Fundación Alternativas is composed as follows: Diego López Garrido (Director), José Luis Escario (Coordinator), Nicolás Sartorius, Juan Moscoso, Carlos Carnero, Vicente Palacio, Manuel de la Rocha Vázquez, José Candela, Jesús Ruiz-Huerta, Enrique Ayala, Carlos Closa, José Manuel Albares, María Muñiz, Emilio Ontiveros, María Joao Rodrigues, Francisco Aldecoa, Soledad Gallego, Irune Aguirrezábal, Josep Borrell and Xavier Vidal-Folch. Permanent guests at meetings of the Council are Lothar Witte, Delegate to Spain of the Friedrich-Ebert-Stiftung, and María Pallares, programme coordinator, also of the Friedrich-Ebert-Stiftung.

2. Restoring the public accounts of member states to financial health must be quantitatively and temporally compatible with a sustainably growing economy and the welfare state. For this reason, the deficit reduction target of 3 per cent set by the European Council should be pushed back to 2016.
3. The funding of growth can no longer rely on net borrowing but must be based on progressive tax increases on higher incomes, a Europe-wide financial transaction tax and more decided action by the European Investment Bank (EIB). The cost of debt market issues must also be lowered through the implementation of a suitable European Central Bank (ECB) monetary policy and the creation of Eurobonds, using, as appropriate, redemption funds or partially mutualised sovereign debt of up to 60 per cent – at least – of gross domestic product (GDP).
4. A key component of European economic policy must be a concerted effort to enhance competitiveness following the guidelines laid down in the Europe 2020 strategy, whose objectives need to be revived, especially those referring to investment in R+D+I and education. Competitiveness should not be identified with labour adjustments, but with technological innovation and training.
5. The ECB should, by imposing conditions for the provision of liquidity, oblige financial institutions to supply sufficient credit to the economy, particularly to small and medium-sized enterprises (SMEs).

Economic Integration

6. Definitive steps towards the creation of a banking union, fiscal union and economic union must be taken in 2013, with a view to overcoming the design deficit of the Economic and Monetary Union (EMU), which is based merely on a common currency shared by 17 countries.
7. Banking union, as a fundamental step towards economic union, needs to be implemented as soon as possible. It should include a single settlement mechanism, a common deposit guarantee fund and ECB oversight of all banks. ECB governance proceedings should be made public and the ECB should, in the medium term, add economic recovery and growth goals to its inflation and financial stability targets (as foreseen in the EU treaties). This will naturally require that its statutes be reformed at some point soon.
8. The EU needs to use its authority as the world's largest economy to ensure the supremacy of political power over the kind of financial

power that caused the economic crisis. The EU should implement a ban on member states and companies using offshore tax havens and, likewise, restrict speculative use of hedge funds (or any other kind of high-risk financial engineering instruments) in financial and EU sovereign debt markets.

9. Fiscal union cannot be limited to simple ex ante control and supervision of national budgets but requires tax harmonisation, especially of corporate and capital gains taxes, to avoid tax dumping.
10. The EU needs to appoint, with the rank of vice-president, a finance minister and an economics minister for the European Commission.
11. The EU budget should be progressively based on European taxes and should enable EU institutions to discharge the functions attributed to them by the treaties, while prioritising, in the immediate future, convergence between economies, economic growth and job creation. The amount of the budget, as it stands, is well below what would be needed to meet these objectives. A fiscal instrument should be created – which could be funded through a financial transactions tax – that would aid the implementation of a convergence and cohesion policy.

The European Social Model and the Social Stability Pact

12. The EU needs to promote a new European social contract along the following lines:
 - Adoption of a European emergency action plan, financed by mutualised debt and EIB loans, that promotes economic growth and employment, especially for young people.
 - Adoption of a European wage policy that reflects productivity gains and implementation of a European minimum wage.
 - Support for a social security system that ensures a high level of health, family, unemployment and retirement protection. Consideration of the possibility of implementing unemployment insurance to complement national subsidies in the Eurozone countries.
 - Implementation of guarantees to strengthen collective bargaining and worker codetermination.
 - Inclusion, in a reformed treaty, of a social progress clause that guarantees basic social rights and endorses the European social model.

The EU as a Global Player: Foreign Policy, Security and Defence

13. EU foreign policy continues to be hampered by difficulties in achieving consensus between states. In 2013, special efforts need to be expended on agreeing common formal positions regarding Iran, Syria, Sahel, climate change and fighting terrorism.
14. The EU should strengthen its development cooperation policy in accordance with the following general criteria:
 - Pooling and sharing – that is, Europeanising – resources so as to achieve synergies and greater efficiency.
 - Focusing on technical assistance with the aim of creating infrastructure, strong institutions and adequate social services and of laying solid foundations for development.
 - Setting geographic and thematic priorities in order to avoid dispersion.
15. In this crucial period of change, the EU needs to strengthen cooperation with its southern Mediterranean neighbours through a greater presence and the provision of more political support, resources and technical training.
16. To ensure that it does not remain a dead letter, the Strategic Framework on Human Rights and Democracy and the corresponding Action Plan, adopted in mid-2012 in response to an initiative by the High Representative for Foreign Affairs and Security Policy and the European Commission, needs to be applied in 2013.
17. The European Security Strategy needs to be updated in 2013. Specifically, as established in Article 42.6 of the Treaty on European Union, permanent structured cooperation needs to be launched as part of the common defence policy, with a view – given new security and defence demands – to strengthening shared powers, including in relation to joint rapid-deployment forces.
18. To renew its aspirations to being a global player, the EU needs to strengthen its regulatory powers and to shape global governance in the area of human rights, death penalty elimination and democracy.
19. The Eurogroup should promote unified representation of the euro in the form of a single »euro seat« on the Executive Board of the International Monetary Fund (IMF).
20. European countries represented in the G20 should seize the moment of relative recovery in market confidence in the euro to ensure that the agenda of the 2013 G20 Summit, to be held in St Petersburg (Russia) in September, includes growth as a priority and reflects the EU commitment to global economic recovery, with EU progress on debt, defi-

cits, financial restructuring, banking oversight, labour markets and competitiveness recorded in its Accountability Report.

21. The EU should seize the moment to cooperate with the Obama administration on foreign policy and security and also on a solution for the economic crisis. The EU and the USA should move firmly towards the signing of an agreement on free trade and transatlantic market regulation.

Deepening Democracy and Citizen Participation

22. The EU needs to offset the power of states with the power of citizens. To do this, it must take advantage of all the tools provided in the new Lisbon Treaty, including participatory democracy, enshrined in Article 11 of the Treaty on European Union and in the Charter of Fundamental Rights. By implicitly confirming that the will of the citizens and states of Europe is to build a common future in the EU, the principles of intergovernmental federalism proposed by the Lisbon Treaty will be advanced.
23. The 2014 EU elections should be politicised to ensure that citizens are offered clearly differentiated options and candidates. Each European political party should announce its President-to-be of the European Commission should they win the elections and a European Parliament majority.
24. The exercise of European citizenship rights needs to be stimulated by encouraging participatory democracy, which allows, for instance, the presentation of popular legislative initiatives based on signatures collected in any number of states. In 2013, in fact, the EU celebrates the European Year of Citizens.
25. The EU needs to lead, building on the opportunities offered by information technology, the expropriation of new participatory rights for citizens who, bearing the brunt of a devastating crisis, are demanding a presence on the political scene and a meaningful relationship with their democratically elected representatives. Regular consultations of European citizens, free Internet access, control over decisions by powerful private interests and consumer rights are just some issues that the EU must urgently address.
26. The multiannual financial framework should be modified to coincide in time and duration with the European Parliament elections, so that citizens can vote according to electoral manifestos and regarding the distribution of European funds.

27. The growing influence of xenophobic and populist movements of the extreme right that threaten internal cohesion and common values must be tackled as a matter of urgency. This could be done in an ambitious programme that promotes, through the broadcast media, education initiatives in schools and social and cultural exchanges, values of freedom, democracy and respect for human rights and intra-EU solidarity.

European Constitutional Reforms: Towards a Federal Europe

28. A major challenge lies ahead in the European Parliament elections of 2014. During 2013, therefore, programmes should be prepared that represent genuine Europe-wide political parties – rather than mere coordinators of national parties. These programmes should make reference to the launch of a constituent process of treaty reforms, leading to political union and to a new institutional architecture, while taking account of the following:

- Election of the Commission President by the European Parliament after each election. Possibility of a constructive vote of no confidence by the European Parliament in the Commission President.
- Election of Commissioners by the European Parliament on the basis of proposals by the Commission President and strengthening of parliamentary control over the Commission.
- For the European Parliament, full powers to undertake legislative initiatives and strengthened control over EU economic, foreign and common security policies.
- For the European Council, maintenance of its co-legislating capacity as a federal second chamber.
- European Council appointment and European Parliament ratification of the President of the ECB.
- Strengthening of the Committee of the Regions.

29. A major goal is to convene a European Convention after the 2014 elections and, once economic recovery is under way, to move towards a federal Europe. Aside from the proposals for institutional reforms noted above, this Convention should also address:

- Fundamental rights and the fostering of citizenship.
- Ground rules for the European welfare state.
- Fundamental principles regarding the delimitation of exclusive powers for the EU and for its member states.

For the future, the revision of treaties in matters of relevance should apply this procedure: (a) Convention; (b) approval by a qualified majority of the European Parliament; (c) approval by a super-qualified majority of the European Council; and (d) a Europe-wide referendum. The rule of unanimity for any EU reforms should be abolished, except regarding new members, as a way of avoiding institutional impasses and deadlocks when confronted with crisis situations.

30. A European referendum should be convened to approve the results of the Convention, once European electoral legislation has been reformed to make it more uniform.

Biographies

José Manuel Albares. Career diplomat, currently the Deputy Director for Sub-Saharan Africa at the Spanish Ministry of Foreign Affairs and Cooperation. He has also served as Spanish Consul in Colombia and member of the Permanent Delegation of Spain to the OECD in Paris, during which time he filled the position of Vice-Chairman of the organisation's Development Assistance Committee (DAC). Albares has also held the position of Head of the Department for Cooperation with Sub-Saharan Africa in the AECID. He is the author of various studies on foreign policy and cooperation development, as well as numerous press articles on these topics. He has been visiting professor at universities in Spain and North America, as well as the L'Institut d'Études Politiques (Sciences-Po) in Paris and holds a Bachelor of Laws and a Diploma in Business Studies from the University of Deusto.

Francisco Aldecoa. Professor of International Relations at the Complutense University of Madrid (2000) and formerly professor at the University of the Basque Country (1990). He has held the Jean Monnet chair, conferred by the European Commission, since 1994 and was awarded an honorary doctorate by the University of Bucharest in 2009. Aldecoa is a disciple of Antonio Truyol y Serra, a distinguished professor and theorist on the process of European construction. From May 2002 to May 2010, he

served as Dean of the Political Science and Sociology Faculty of the Complutense University of Madrid. He was president of the Spanish Association of Professors of International Law and International Relations from 2005 to 2009. He is the current Director of the Centre for Studies in Management, Analysis and Evaluation at the Complutense University of Madrid.

Niels Annen. Foreign Affairs Analyst for Friedrich-Ebert-Stiftung. He has served as a member of the German Bundestag and is currently a member of the executive committee of the SPD. Prior to being elected to the German Bundestag, he was chairman of the SPD youth organisation. Niels Annen holds a licentiate degree in History and Spanish from Humboldt University Berlin and a Masters in International Public Policy from the Johns Hopkins School of Advanced International Studies in Washington DC.

Enrique Ayala. Brigadier General of the Army Reserves. Ayala holds a degree in International Relations from the Centre for International Studies. He has served as military attaché to the Spanish Embassy in Germany and Chief of Staff of the Eurocorps. An international policy analyst specialising in the European Union, for the past seven years he has been a regular contributor to the "Carta de Europa" section of the journal *Política Exterior*. He is a member of the Euro-

pean Affairs Advisory Committee of Fundación Alternativas.

Ángel Bergés. Holds a degree in Business Studies from the Autonomous University of Barcelona and a PhD in Finance from Purdue University in Indiana (United States). He is Professor of Financial Economics and Accounting at the Autonomous University of Madrid. Bergés has published 12 books and more than 100 articles in Spanish and foreign journals on various aspects of financial markets. He was the first Spaniard to serve as president of the European Finance Association. Chief Executive Officer and founding partner of Analistas Financieros Internacionales (AFI), he is also the Spanish representative in the Securities and Markets Stakeholders Group, an advisory body of the European Securities Markets Authority (ESMA). Bergés was a member of the Technical Committee of the Ibox Index from its founding in 1990 until 1997.

Klaus Busch. Born in 1945, Busch is professor emeritus in European Studies. From 1999 to 2004, he served as Vice-President of the Institute of European Studies at the University of Osnabrück. His main research areas are economic and monetary problems related to European integration and the European Union's social and wage policies. He is the author of the corridor model, a special strategy for European social policy. Busch has recently served as advisor to various trade unions within the EU, including ver.di, a German trade union representing workers in the service sector.

Carlos Carnero. Managing Director, Fundación Alternativas. Carnero has served as a member of the European Parliament, Spanish ambassador-at-large for European integration,

and Vice-President of the Party of European Socialists. He was also a member of the Convention that drafted the European Constitution. He has collaborated on several books, including *Construyendo la Constitución Europea. Crónica política de la Convención*, *Manual de Instrucciones de la Constitución Europea*, *Europa en la encrucijada* and *La diplomacia común europea: el servicio europeo de acción exterior*. Carnero holds a degree in Tourism. He is a visiting professor in the master's programme of the Institute of European Studies at the University CEU-San Pablo and has led several summer courses at the Complutense University of Madrid on the EU. The Spanish government awarded him the Order of Constitutional Merit and the Order of Civil Merit for his work related to the European Union and foreign affairs.

Carlos Closa. Senior Research fellow at the CSIC, Closa holds an MA in European Integration and a Ph.D. in Political Science from the University of Hull (United Kingdom). From 2004 to 2008 he served as Deputy Director of the CEPC (Ministry of the Presidency) and from 2005 to 2009 he was a member of the European Commission for Democracy through Law (Venice Commission, Council of Europe) representing Spain. He has been a professor at the University of Zaragoza and the Complutense University of Madrid, as well as visiting professor at the College of Europe in Bruges. He has also been a Visiting Fellow at the Minda de Gunzburg Center at Harvard University, a Jean Monnet Fellow and a Salvador de Madariaga Fellow at the European University Institute (IUE) in Florence, Italy. He is currently Emile Noël Fellow at New York University (NYU) and Affiliated Scholar in EUI's Global Governance Programme.

Raúl Compés López. Received a Ph.D. in Agricultural Engineering from the Polytechnic University of Valencia in 1998. López has taught at PUV since 2000 and is the Director of the university's master's programme in Planning and Management for Businesses Involved in Foreign Trade. His academic and professional work is focused on economics and policy related to the agri-food sector, particularly in the areas of international trade, organisation and public policy, development and logistics. He is Vice-President of the Asociación Española de Economía Agraria and author of numerous reports and studies carried out for public institutions, such as the European Parliament, the Ministry of Agriculture of the Community of Valencia, the Spanish Ministry of Agriculture, Fisheries and Food and the Spanish Ministry of Environment and Rural and Marine Affairs (MARM). He is also advisor to the Corporación Andina de Fomento.

Manuel de la Rocha Vázquez. Obtained his degree in Economics and Business Administration from the Autonomous University of Madrid and a Master in Economic Policy Management from Columbia University in New York. He has worked for several international organisations, including the European Commission, the African Development Bank and the World Bank. From 2003 to 2007, he was an economist with the Economic Policy Unit of the World Bank's office and was stationed for the final three years of this period in Nairobi, Kenya. During the period 2007–2010 he served as advisor to the Director General for Development Policies in the Spanish Ministry of Foreign Affairs and Cooperation (AECID). Author of numerous publications on development and international economics, he is the current coordinator for panels on International Economics and Sub-Saharan Africa at the Fundación Alternativas.

José M. García Álvarez-Coque. Holds a Ph.D. in Agricultural Engineering. A professor of Applied Economics, he has served as advisor to a number of European institutions and international organisations, including WHO, CIHEAM, IFPRI and the OECD. García Álvarez-Coque has participated in research and cooperation projects in the Andean countries, Central America, the Middle East, North Africa and East Asia. From 2001 to 2007 he was president of the Asociación Española de Economía Agraria. He is currently the director of the Polytechnic University of Valencia's masters programme in Agri-food and Environmental Economics.

Miguel Ángel García Díaz. Holds a degree in economics from the Complutense University of Madrid. At present, he is the Director of the Confederal Economic Cabinet of Comisiones Obreras and assistant professor of economics at Rey Juan Carlos University in Madrid. He is a member of the General Council of the INSS and the SEPE. He is author of numerous publications and has participated in various research projects related to monetary and fiscal policy from the perspectives of both tax revenue and public expenditure. His publications include annual reports on the state of the Spanish economy, reports on every general state budget since 2003, and analyses of the budgets of Spain's autonomous communities and the financing system for these communities. Since 1998 he has also participated in various rounds of negotiations with the Spanish employers' association (Patronal) and the Spanish government regarding labour issues, social security and, most particularly, the Spanish pension system.

Björn Hacker. Born in 1980, Hacker conducts research on economics and social policy for the Friedrich-Ebert-Stiftung in Berlin and is also visit-

ing professor at the Hochschule Fulda – University of Applied Sciences. He holds a Master in European Affairs from the Institut d'Études Politiques in Paris (Sciences-Po) and a Ph.D. in Political Science from the University of Osnabrück. His main areas of research are European economic governance, the theory of European Integration and the comparative study of social welfare policies in Europe.

Diego López Garrido. Chairman of the Council on European Affairs at the Fundación Alternativas and member of the Scientific Committee of the Foundation for European Progressive Studies (FEPS). He is MP for Madrid and spokesperson for the Socialist Group in the Parliamentary Defence Committee and member of the Parliamentary Assembly of NATO (Vice-Chair of the Mediterranean and Middle East Special Group and Vice-Chair of the Subcommittee on Transatlantic Economic Relations). A member of the PSOE Federal Committee, he has also assumed the role of spokesperson for the Socialist group in the Spanish Parliament (2006–2008). From April 2008 to December 2011, he was Secretary of State for the European Union and coordinated the Spanish Presidency of the EU in 2010. López Garrido was a member of the Convention that drafted the European Constitutional Treaty, the accord that paved the way for the Lisbon Treaty, as a representative of the Spanish Parliament (2002–2003). He is an economist and professor of Constitutional law. Author of various books on human rights, economics, politics, contemporary history and European law, he is also a regular contributor to the Spanish daily *El País*.

Jordi Marsal. Holds a degree in philosophy and literature from the University of Barcelona and a diploma in Advanced Military Studies

from CESEDEN. He has been a professor of Ancient Philosophy at the University of Barcelona. From 1979 through 1995 he served as a member of the municipal council of Manresa, and from 1982 to 2008, he was the Socialist Deputy for Barcelona in the Spanish House of Deputies, where he served on the chamber's Defence, Foreign Affairs, Industries and Public Administration Committees and chaired the Petitions Committee. He served as Head of the Spanish Delegation to NATO and advisor to the Spanish Ministry of Defence from 2005 to 2008. He is currently civil attaché to the Director of CESEDEN. Marsal is author of a range of publications on security and defence and has participated in numerous conferences on these topics.

Pedro Moraleda. Holds degrees in Law and Business Administration and has more than twenty-five years of experience in the energy sector. From January 2009 to December 2012 he served as General Director of the Mediterranean Energy Observatory (OME) headquartered in Paris. He has been in charge of and collaborated on numerous publications and research projects for international institutions on energy markets and forecasts, particularly on the subject of natural gas and liquefied natural gas. Moraleda is a member of the European Commission's Gas Advisory Council and collaborates with the Real Instituto Elcano's Energy Group.

Regino Moranchel. Holds a degree in Economics and Business Administration from the School of Engineering of the University of Alcalá de Henares. He had a long and successful career at Indra, where he started out as Chief Project Engineer for Air Traffic Controls. In 1993, he was given responsibility for the company's automation and controls division. In 1995, he was put in charge of Indra's IT business and rose

to the position of General Director for Operations in 1999. He was named CEO of the company in 2001, a position he held until June 2011. From December 2010 until his departure in November 2012, Moranchel served as Indra's Executive Vice-President.

Emilio Ontiveros. Holds licentiate and doctorate degrees in Economics and is Professor of Applied Economics at the Autonomous University of Madrid where he served as Vice-Rector for four years. Ontiveros is founder and President of *Analistas Financieros Internacionales (AFI)* and a member of the boards of directors of several companies. He has been a Fellow of the Royal Complutense College, Harvard University and a visiting scholar at the University of Pennsylvania's Wharton School of Management. He serves on the editorial boards of several scientific and professional journals and has been the Director of the *Revista Economistas* since it was founded in 2011. He is also the author of numerous articles that have appeared in specialist journals and various books, including *Global Turning Points. Understanding the Challenges for Business in the 21st Century* and *Una nueva época. Los grandes retos del siglo XXI* (both co-authored with Mauro Guillén) and *El Rescate* (co-authored with Ignacio Escolar).

Vicente Palacio. Holds a Ph.D. from the University Complutense of Madrid and currently serves as Deputy Director of the Observatorio de Política Exterior, Fundación Alternativas. He has directed and coordinated research for the Socialist group in the Spanish Parliament, the Cabinet of the Spanish President and the Ministry of Foreign Affairs and Cooperation. Palacio has been Associate Professor of Internal Relations at Syracuse University (US) and a visiting fellow and researcher at Harvard University's Depart-

ment of Government. He is author of the upcoming book *Sueños de Obama: EE. UU. y la primacía global*, as well as dozens of analyses and articles for the specialised press on the subjects of Spanish and EU foreign policy, transatlantic relations and EU–Latin American relations. He is a frequent contributor to *El País* and CNN's Spanish language news channel.

Teresa Ribera. General Director for Strategic Development and New Markets for Isofotón, a pioneering company in solar energy. As Secretary of State for Climate Change 2008–2011, she was responsible for Spain's environmental policies, as well as the Spanish National Meteorological Agency. Prior to this appointment, she was Director General of Spain's office on climate change from 2004 to 2008 and held a variety of technical positions in the Ministries of Public Works, Transportation, and Environment. Ribera earned a degree in Law and holds a Diploma in Constitutional Law and Political Science from the Centro de Estudios Constitucionales. She belongs to the Cuerpo Superior de Administradores Civiles de Estado and has been an assistant professor of public law at the Autonomous University of Madrid. She has participated in numerous conferences and has been a frequent contributor to publications on issues related to climate change, energy, global governance and European policy-making.

Domènec Ruiz Devesa. Partner and Director of Gobernia Consulting, S.L. and specialist in European economic policy and the international monetary system. Devesa holds degrees in Law and Economics from the University Carlos III, a degree in Political Science and Sociology from the UNED and a Master in International Relations with a concentration in European Studies from Johns Hopkins University. He has provided

consulting services for international organisations such as the World Bank, the Inter-American Development Bank and the Union for the Mediterranean, international consulting firms including Oxford Policy Management and Family Health International and think tanks such as the Fundación Alternativas, for which he serves as a member of the editorial advisory board for the journal *Temas para el Debate*. In 2011 he was advisor to the Spanish Minister for the Presidency.

Nicolás Sartorius. A lawyer and journalist by profession, Sartorius is Executive Vice-President of the Fundación Alternativas and Director of the foundation's Observatorio de Política Exterior Española (OPEX). Imprisoned for several years during the Franco dictatorship for his trade union activities, he was co-founder of Comisiones Obreras and member of the Spanish Parliament for the Spanish Communist Party and Izquierda Unida for several terms up until 1993. He participated in social and political ne-

gotiations during the Spanish Transition. Since that time, he has devoted the greater part of his time to writing. He is a frequent contributor to newspapers such as *El País* and is the author of numerous essays including *El resurgir del movimiento obrero*, *El sindicalismo de nuevo tipo*, *Un nuevo proyecto político*, *Carta a un escéptico sobre los partidos políticos*, *La memoria insumisa: sobre la dictadura de Franco*, *El Final de la Dictadura: la conquista de la libertad en España* and contributor to *Una nueva Globalización: propuestas para el debate*.

Lothar Witte. Director of the Friedrich-Ebert-Stiftung (FES) in Madrid. Prior to assuming this post, he was representative of the FES in Tunisia. He has worked as a political analyst for the FES in Bonn and as a freelance development policy consultant. Witte holds a Masters in Sociology from the University of Berlin and an MA in Economics from Vanderbilt University in Nashville, Tennessee.

Acronyms

ACP: African, Caribbean and Pacific Group of States.

EDA: European Defence Agency.

AFISMA Mali: African-led International Support Mission to Mali.

HR: High Representative of the Union for Foreign Affairs & Security Policy.

ECB: European Central Bank.

EIB: European Investment Bank.

Burden Sharing: Loss-sharing scheme in the restructuring or resolution of financial institutions.

ECOWAS: Economic Community of West African States.

CIUS: Committee of European Users of Sugar.

UNFCCC: United Nations Framework Convention on Climate Change.

COMAGRI: European Parliament Committee on Agriculture and Rural Development.

PSC: Political and Security Committee.

EUISS: European Union Institute for Security Studies.

EUNAVFOR: European Union Naval Force.

EUROFOR: European Rapid Operational Force.

EUROMARFOR: European Maritime Force.

Eurosystem: The Eurosystem consists of the European Central Bank and the central banks of the member states that belong to the eurozone.

EUTM Mali: EU training mission in Mali.

FED: Central banking system of the United States.

EFSF: European Financial Stability Facility.

IMF: International Monetary Fund.

FOBR: Fund for Orderly Bank Restructuring.

IED: Improvised explosive device.

IFAD: International Fund for Agricultural Development.

ICTSD: The International Centre for Trade and Sustainable Development.

ISTAR: Intelligence, Surveillance, Target Acquisition and Reconnaissance.

JEMAD: Chief of the Defence Staff.

LTRO: Long-term refinancing operation.

OMC: Open Method of Coordination.

ESM: European Stability Mechanism.

MENA: Middle East and North Africa.

MFF: EU multiannual financial framework.

MOU: Memorandum of Understanding.

ESM: European Social Model.

OACI: International Civil Aviation Organization.

OCDE: Organisation for Economic Co-operation and Development.

WTO: World Trade Organization.

MTO: Medium-term budgetary objectives.

OMT: Open Market Transactions.

BEPG: Broad economic policy guidelines.

NATO: North Atlantic Treaty Organization.

CAP: Common Agricultural Policy.

EDP: Excessive deficit procedure.

MIP: Macroeconomic Imbalance Procedure.

SGP: Stability and Growth Pact.

CFSP: Common Foreign and Security Policy.

ESDP: European Security and Defence Policy.

GDP: Gross domestic product.

EEAS: European External Action Service.

SAREB: High Yield Real Estate Spanish Junk Fund.

SATCOM: Generic term for satellite communications.

EU: European Union.

EMU: Economic and Monetary Union of the European Union.

UNIFIL: United Nations Interim Force in Lebanon.

WFP: World Food Programme.