EUROPEAN POLICY CENTRE

28.03.2011

Post-Summit Analysis

A quantum leap in economic governance – but questions remain

Summary

EU leaders put the final pieces of the new, enhanced economic governance puzzle in place at their 24-25 March Summit, agreeing key elements of the 'grand bargain' which includes treaty change, the permanent bail-out mechanism, the 'Euro Plus Pact', the 'six pack' of legislative procedures, the European semester, and a second round of bank stress tests. But this EPC analysis by Janis A. Emmanouilidis argues that while European Council President Herman Van Rompuy was right to herald this as a "turning point in the management of the crisis", several key questions remain unanswered. It also assesses the outcome of the Summit discussions on developments in Libya and the aftermath of the Japanese earthquake and tsunami.

Full report

Pressures and expectations were high ahead of the 24-25 March EU Summit. After 15 months of enduring crisis, political observers, the media and markets expected EU leaders to seal the final deal on the Union's new model of economic governance.

They did not disappoint, although their achievement was overshadowed by the collapse of the Portuguese government, prompting renewed speculation about an imminent need for a bail-out; by unfolding events in Libya; and by mounting concerns about the devastating earthquake and tsunami in Japan on 11 March and the subsequent nuclear disaster in Fukushima.

Nevertheless, the European Council succeeded in taking key decisions on a limited treaty change, on the detailed features of the European Stability Mechanism (ESM), and on the establishment of a so-called 'Euro Plus Pact'. These and other decisions mark a "turning point in the management of the crisis", as European Council President Herman Van Rompuy put it. However, the crisis is not over and it is much too early to deliver a final verdict, as the results will be tested and will have to prove themselves over time.

Frayed tempers – but unexpected progress ahead of the Summit

The 24-25 March European Council was the third such gathering of EU leaders already this year, and many issues related to economic governance had been discussed and partially settled at previous Summits. However, the months since the last 'ordinary' Summit in December 2010 had by no means been free of political quarrels and market turmoil, raising doubts at times about whether the remaining outstanding issues could be resolved.

At the informal European Council on 4 February ostensibly devoted to energy and innovation, Germany and France infuriated other Member States by presenting a 'Pact for Competitiveness'. Berlin and Paris had announced plans to come forward with additional proposals to better harmonise Member States' economic policies in December, but the content of the Pact drafted in Berlin came as a surprise, as EU partners had not been consulted beforehand. It included a six-point plan calling for abolition of salary indexation systems, the introduction of a common corporate tax base, adjustments to pension schemes in light of demographic developments, the insertion of a debt alert mechanism into national constitutions, the mutual recognition of educational diplomas, and the establishment of national crisis management regimes for banks.

The German-Franco proposals ran into fierce opposition from numerous Member States and EU institutions. The vast majority of countries condemned what they saw as an attempt to present them with a *fait accompli* and every item of the six-point plan was (heavily) criticised by one or more EU governments.

In particular, MEPs were furious that the Pact took an intergovernmental approach outside the EU framework, leaving the European Commission and European Parliament (EP) more or less on the sidelines. Commission President José Manuel Barroso also warned against plans to set up rules outside the existing Treaties, and Economic and Monetary Affairs Commissioner Olli Rehn even questioned the Pact's added value, arguing that most of its ideas overlapped with the Commission's Annual Growth Survey, unveiled in January 2011, which included *inter alia* a blueprint for increasing retirement ages for state pensions, revising rules that link pay rises to inflation, and allowing EU-wide recognition of national professional qualifications. A more fundamental criticism came from many non-euro countries, which feared the Pact would create a two-speed Europe if they were excluded.

Political observers argued that the Pact had been mostly tailored for domestic German consumption, designed to calm an increasingly EU-hostile German public and reassure forces in Chancellor Angela Merkel's own coalition government that its EU partners would have to 'pay a price' for Germany's readiness to set up a €700 billion permanent crisis mechanism. The German government (supported by the French), on the other hand, argued that the Pact was necessary to increase the competitiveness of euro-zone countries in order to reduce imbalances, foster economic convergence in the euro area and strengthen Europe's global competitiveness.

Despite all the criticism, Chancellor Merkel and French President Nicolas Sarkozy stuck to their guns and President Van Rompuy (supported by President Barroso) was asked to undertake consultations with Heads of State or Government to work out a compromise, which was then discussed at an extraordinary euro-zone Summit on March 11.

The fact that the non-euro countries were excluded from this gathering – although their leaders were already in town for an emergency meeting on North Africa – caused a great deal of bad blood, as non-Euro countries felt deeply humiliated, and with good reason. Excluding future euro-zone countries from a Summit discussing the future ground rules for Economic and Monetary Union was a mistake: the new Member States were obliged to sign up to the euro when they joined the EU and will have to abide by the new rules when they eventually join the common currency. Denying them a seat at the table while the rules of the game were being changed was inherently unfair and short-sighted. But it now seems likely that future Euro Summits will follow a '17-plus' format, including euro-zone countries and those Member States who have committed themselves to a higher level of economic coordination.

In terms of outcome, the Euro Summit surprised most observers – and even some EU governments – as leaders of the 17 euro countries managed to cut a deal on almost all significant elements of the 'grand bargain' well ahead of last week's ordinary European Council. Details of the compromise were then thrashed out by finance ministers ahead of the 24-25 March Summit.

The unexpected deal came as a relief, and EU policy-makers were – for the first time since the outbreak of the crisis – praised for moving more quickly than expected. However, the financial markets remained unstable, especially following Moody's decision to downgrade the credit rating of Greece, citing an increased risk of default or restructuring, and of Spain, due to higher estimates regarding the capital needs of the country's banking system, in the first half of March. A further blow in the run-up to the 24-25 March Summit came when both Moody's and Fitch downgraded Portugal's credit rating.

EUROPEAN POLICY CENTRE

The Portuguese situation deteriorated further when Prime Minister José Socrates' minority government failed to get a new austerity package through parliament on the eve of the Summit, causing his resignation. This has increased the likelihood that Portugal will have to join Greece and Ireland in seeking shelter under the rescue umbrella, requiring a loan of between €60-80 billion. EU leaders expressed their solidarity with Portugal, and there were rumours that core euro-zone countries were pushing Lisbon towards asking for a bail-out to avoid a further turmoil on the markets, which could increase the danger of Spain becoming the next domino to fall. But Prime Minister Socrates argued that "there would be a domino effect" if Portugal failed and turned to the European Financial Stability Facility (EFSF) for help.

However, this year's announcements by Madrid of additional budget cuts, bold pension reforms, privatisation measures, and a plan to recapitalise the regional public savings banks, have eased pressures on the bond market, and there is now also an increasing awareness that the Spanish debt level is much lower than that of Greece, Ireland or Portugal.

There are good reasons to believe that the worst effects of the sovereign debt crisis can be successfully contained to these three 'peripheral' euro-zone countries and, despite all the turmoil, the euro has remained remarkably stable in recent weeks – its value against the US dollar actually increased from around 1.30 to above 1.40 between January and end March. And despite all the controversies and turmoil ahead of the Summit, EU leaders succeeded in taking a number of key decisions which complete the EU's enhanced economic governance puzzle. The 'grand bargain' includes decisions on treaty change, the ESM, the 'Euro Plus Pact', the 'six pack' of legislative procedures and a second round of bank stress tests, as well as concluding the first phase of the new European semester.

Details and dangers of treaty change

The European Council formally adopted a decision amending Article 136 of the Treaty on the Functioning of the European Union (TFEU). This limited treaty change had been 'imposed' by Berlin to avoid a legal clash with the German Constitutional Court in Karlsruhe over the creation of a permanent rescue mechanism and adds the following paragraph to Article 136: "The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality."

This treaty change is being made using the so-called 'simplified revision procedure' introduced by the Lisbon Treaty (Article 48.6 Treaty on European Union), which allows the European Council to adopt a unanimous decision amending all or parts of the provisions of Part Three of the TFEU. The major advantage of this procedure is that it is less complicated and time-consuming than the 'ordinary revision procedure', as it requires neither an Intergovernmental Conference nor a Convention.

The European Council conclusions call for national approval procedures to be launched rapidly, so that the treaty amendment can enter into force on 1 January 2013 after ratification by all EU Member States. Most observers predict that this process will run smoothly, arguing that no government or national parliament will dare to put the creation of the ESM in 2013 at risk.

However, past experience has shown more than once that national ratification processes are not a routine exercise, and that the danger of failure in one or the other Member State cannot be excluded.

The challenge is probably greatest in countries where populist anti-EU rhetoric is already on the rise and in those where increasing parts of the population are suffering from the impact of austerity measures, especially those euro countries which have – or will have to – seek shelter under the existing rescue umbrellas. Nationalists in these Member States might raise the short-sighted but appealing argument that setting up a permanent crisis mechanism is not in their 'national interest' because citizens then run the risk of having to accept severe austerity measures and because national sovereignty is limited by the fact that reform programmes are subject to tight surveillance by a troika including the Commission, the International Monetary Fund (IMF) and the European Central Bank (ECB). Others again could be tempted to link ratification of the amendment to other EU issues, either directly linked to the creation of the ESM or to other topics of particular importance for the country concerned.

The above examples highlight the risk that the entry into force of the new Article 136 could either take longer than expected or even fail. It thus seems advisable to do everything necessary to reduce the danger of this and, in parallel, to devise a 'Plan B' early on to avoid yet another severe destabilisation of financial markets if it should happen.

Features of the European Stability Mechanism

Following the European Council's decision in principle to establish a permanent crisis mechanism in October and December, the deal cut at the Euro Summit on 11 March and the more technical agreements reached between finance minister after that, EU leaders endorsed and fine-tuned the detailed features of the new permanent European Stability Mechanism (ESM) on 24-25 March.

The ESM will replace both the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM). The present *ad hoc* constructions need to be replaced because they were deliberately given a limited three-year lifespan and Berlin had already declared last year that it would not agree to prolong their existence in their current form after 2013. However, governments have now decided that the EFSF will remain in place after June 2013, until all loans have been paid back and all liabilities repaid.

In short, the new ESM is a permanent last-resort rescue mechanism set up outside the EU on the basis of a treaty among euro-zone members, and able to issue triple-A bonds in order to provide, together with the IMF, assistance to euro countries in difficulty, on the basis of strict conditionality.

Governance structure

The ESM will be governed by a Board of Governors and a Board of Directors. The Board of Governors will consist of euro-zone countries' finance ministers as voting members, and the Economic and Monetary Affairs Commissioner and ECB President as observers. As the ESM's highest decision-making body, the Board of Governors will take unanimous decisions on the granting of assistance, the terms and conditions of assistance, and the ESM's lending capacity. The Board of Directors, which will carry out specific tasks delegated to it by the Board of Governors, will include one Director and one alternate Director from each euro-zone country; the Commission and the ECB will each nominate an observer and an alternate. The Board of Governors will appoint a Managing Director, who will chair the Board of Directors and will be responsible for the day-to-day management of the ESM.

Lending capacity and capital distribution

After growing concerns that the current lending capacity of the EFSF might be insufficient, EU leaders decided that the ESM will have an effective lending capacity of €500 billion, to be achieved through a combination of €80 billion of paid-in capital and €620 billion of callable capital and guarantees from euro-zone members. The adequacy of this capacity will be reviewed regularly, and at least every five years.

The €700 billion capital base was necessary to ensure that the ESM will be given a triple-A rating. The paid-in capital (€80 billion) will be phased in from July 2013 in five equal annual instalments. An earlier agreement between finance ministers that half of this capital would be paid in immediately in 2013 and the rest made available over the following three years was overturned at the Summit after Berlin – which will have to come up with around €22 billion of the €80 billion – asked for a reduction in annual payment instalments. In line with the EFSF, the ESM will seek to supplement its lending capacity through the participation of the IMF and non-euro-zone EU Member States.

No definite agreement was reached on how to increase the effective lending capacity of the temporary EFSF, which can currently only lend approximately half of its nominal €440 billion capacity because of the guarantees necessary for a triple-A rating. However, governments have committed themselves to find a compromise on this by the summer. This delay was mainly a consequence of the political turbulence in Portugal and Finnish Prime Minister Mari Kivinemi's refusal to endorse an agreement now, as she is facing elections in April and the main opposition parties – including the populist True Finns party – are campaigning strongly against an increase in the EFSF's lending capacity.

The capital that individual euro-zone countries will have to contribute to the ESM will be calculated on the basis of the ECB key. However, Member States whose GDP per capita is less than 75% of the EU average will benefit from a temporary reduction in their contribution for 12 years after their entry into the euro area. This decision to bestow a 'rebate' was taken after six countries from Central and Eastern Europe, including euro members Estonia and Slovakia as well as non-euro countries Bulgaria, Czech Republic, Latvia and Lithuania, had threatened to block the entire reform, arguing that the ECB key was unfair.

Ultima ratio, unanimity and strict conditionality

The ESM will be used as an *ultima ratio* – i.e. it will 'only' provide financial assistance if this is deemed indispensable to safeguard the stability of the euro as a whole. The decision to activate the ESM will be taken by unanimity on the basis of a public-debt sustainability analysis of the Member State concerned conducted by the Commission and the IMF, in liaison with the ECB.

In other words, every country will be able to block the use of the ESM if its government (or parliament) deems that the stability of the entire euro zone is not threatened by financial problems in one or more Member States. These provisions are designed to reassure stronger euro-zone countries such as Austria, Finland, Germany or the Netherlands that they cannot be 'forced' to provide loans. Seen from the perspective of weaker countries, this means that a euro-zone country facing financial turmoil cannot be certain that it will receive assistance if partner countries can convincingly argue that the stability of the euro area as whole is not endangered.

The ESM can grant short- or medium-term stability support. Access to ESM Stability Support (ESS) will be subject to strict conditionality under a macro-economic adjustment programme. In other words, countries asking for assistance will have to present a set of concrete austerity measures and structural reforms to convince partner countries that they 'deserve' support. The Greek and Irish examples have shown that countries seeking shelter under a rescue umbrella will lose parts of their national sovereignty, as they will be subject to strict surveillance by the Commission, IMF and ECB. That is the main reason why the Greek, the Irish and now the Portuguese governments have done their utmost to avoid asking for a bail-out, and no other Member State is likely to be eager to do so in future for the same reason, limiting the risk of so-called 'moral hazard'.

Scope

There has been an intense debate in the last couple of months over whether funds provided by the EFSF or the ESM should be used for additional purposes beyond providing loans to struggling governments.

Peripheral countries and ECB President Jean-Claude Trichet have argued that the EFSF/ESM should also be used to purchase bonds of distressed countries directly or allow its loans to be used by governments to buy back their own debt. Until now, this has only been done by the ECB, acting as a defender of last resort, buying up bonds already issued by weak euro-zone countries on the secondary market to stabilise peripheral bond markets and prevent contagion. Others – including France and Spain – proposed that funds should also be used for short-term credit lines to governments struggling to borrow money but not in need of multi-annual bail-out packages. Finally, the EFSF/ESM could, as the IMF and others have suggested, provide financial support to help stabilise European banks, which are still at the heart of the crisis. Some, like Wolfgang Münchau of the

Financial Times, have even argued that the EFSF/ESM should be charged with the "restructuring and downsizing of the European banking sector."

EU leaders did not agree to take up any of these suggestions. The use of the EFSF and the ESM will be 'limited' to providing financial assistance in the form of loans. However, the ESM may, in exceptional cases, intervene in the debt primary market to buy bonds on the basis of a macro-economic adjustment programme "with the objective of maximising the cost efficiency of the support".

This decision was taken in the face of strong Dutch and German resistance to the idea of allowing the EFSF/ESM to buy bonds on the secondary market. The German government coalition parties in the Bundestag had even issued a resolution explicitly rejecting the possibility of bond-buying and buy-back arrangements, thus limiting Berlin's room for manoeuvre on this issue. The fact that the ESM will, in exceptional circumstances, be able to purchase debt on the primary market was downplayed by Chancellor Merkel, who argued that this concession would not have a "huge impact".

The decision not to allow the EFSF/ESM to buy bonds is a heavy blow for President Trichet and the ECB, who had hoped that the Bank could 'take over' more than €77 billion of peripheral EU countries' bonds, which the ECB has acquired since May 2010. The ECB's bond-buying programme has been contentious since its launch, but it now seems that it will have to continue its so-called securities market programme in order to stabilise peripheral bond markets, although this clearly threatens the ECB's independence.

The fact that the ESM will not be able to purchase bonds on the secondary market rules out a less disruptive form of partial restructuring: that struggling governments could have bought their own bonds from the secondary market or from the ECB for less than their nominal value and then swapped them for new bonds.

This idea had already been floated with regard to Greece, with suggestions that Athens could get additional loans of €50 billion to buy back own bonds currently valued at around 70% of their nominal value. This would not be possible under the ESM framework. However, one cannot exclude the possibility that the special lending arrangements set up for Greece might be used in this way after all, even if the ESM will not be allowed to do so. But in any case, the effects of a bond swap worth €50 billion would be rather limited as it would relieve Greece's debt ratio by 'merely' 6-9% – not much, considering that its total debt will reach around 160% of GDP in the years to come.

Pay-back period and interest rates

The length of programmes and the maturity of loans will depend on the nature of imbalances and the prospects of the beneficiary country regaining access to financial markets. EU leaders have decided that interest rates for loans provided by the ESM will remain above the funding costs of the facility, with an adequate mark-up for risk.

The ESM will be able to lend at a fixed or variable rate. The Mechanism will charge an additional 2% for loans up to three years, with an additional 1% surcharge for loans longer than three years. This will make future loans 'cheaper' (the EFSF has, until now, offered loans with a margin of 300 basis points for up to three years and 400 basis points over three years).

Concerning the loans already committed to Greece, the Euro Summit on 11 March had already decided to ease its rescue terms in exchange for the Greek government's decision to commit itself to a detailed and more ambitious privatisation programme to bring in an estimated €50 billion in revenue until 2015. In return, the interest rate on the EU's portion of the €110 billion rescue mechanism (€80 billion) was cut from 5.2% to 4.2%. The Greek government had pushed for a 2% reduction, but this was rejected by Finland, France, Germany and the Netherlands. Athens estimates that the 1% cut will reduce its loan costs by €6 billion. Moreover, the Summit agreed to extend the maturity of all programme loans to Greece to 7.5 years, in line with the IMF.

The new Irish government was offered a similar *quid-pro-quo* deal at the Euro Summit, but Prime Minister Enda Kenny resisted pressure from Paris and Berlin to raise Ireland's 12.5% corporate tax rate in exchange for a 1% decrease in the 5.8% interest rate on the EU's portion of the €85 billion joint EU-IMF loan. The Irish rate is roughly 3% higher than the EFSF's current borrowing costs of around 2.9%, but President Sarkozy said that without a "gesture" from the Irish government to raise its corporate tax rate, it was not possible to agree a renegotiation of its loans. The Commission, on the other hand, had backed the Irish position on easing the lending terms, arguing that credit conditions might hamper the country's ability to return to growth and market financing.

The Irish interest rate question was due to be discussed again at the 24-25 March Summit, but was taken off the agenda after a meeting between President Van Rompuy and Prime Minister Kennan. Dublin decided to await for the results of a new round of stress tests on Irish banks, due to be published in the week after the Summit. The interest rate debate could re-emerge if the tests show that Irish banks require extra capital and Dublin then has to ask for additional funds to do this.

Private-sector involvement

EU governments had – under severe pressure from Chancellor Merkel – already agreed in October that the permanent crisis mechanism should involve the private sector in cases of state insolvency. The ESM agreement endorsed by EU leaders on 24-25 March specifies the modalities of this involvement, which will be decided on a "case by case basis" and not following a more automatic procedure, as originally foreseen by Berlin.

Anxious to calm the markets, officials have been particularly eager to downplay the significance of involving the private sector in recent months, arguing that the restructuring procedure will merely replicate existing IMF procedures for dealing with sovereign debt crises. President Trichet has supported this argument, insisting that "Europeans are not introducing a different doctrine".

The decision to involve private creditors only after a case-by-case analysis makes sense for two reasons. First, every case of sovereign default is different and the conditions attached to a potential restructuring will thus have to reflect the debt situation of the country concerned. Second, if financial support leads automatically to debt restructuring, the markets would be tempted to attack the weakest euro-zone members, even if these countries were not yet insolvent.

The detailed terms of the ESM foresee that insolvent countries will have to negotiate a comprehensive restructuring plan with their private-sector creditors with a view to restoring debt sustainability if a macro-economic programme cannot by itself realistically restore the public debt to a sustainable level. The Member State concerned will be required to engage in active negotiations with its creditors to secure their direct involvement in restoring debt sustainability.

To facilitate a restructuring process, standardised and identical collective action clauses (CACs) will be included in the terms and conditions of all new euro-area government bonds from July 2013. These will include aggregation clauses enabling creditors to agree by qualified majority on a legally-binding change to the payment terms (standstill, extension of maturity, interest rate cuts and/or haircuts) if the debtor is unable to honour obligations. To protect taxpayers' money further and send a clear signal to private creditors that their claims are subordinated to those of the public sector, an ESM loan will (unlike the current temporary rescue mechanisms) enjoy preferred creditor status, junior only to the IMF loan.

It is important to note that the detailed procedures for private-sector involvement will not be effective before mid-2013, which means that private investors could be asked to 'pay' their share of a state insolvency much later, probably in the second half of the decade or even later when bonds including CACs reach maturity, and not in the course of the current crisis.

With respect to timing and procedure, EU leaders have agreed that the preparation of the ESM treaty and the amendments to the EFSF agreement necessary to ensure the latter's €440 billion effective lending capacity will be finalised in time to allow both agreements to be signed by the end of June 2011.

Euro Plus Pact – the new kid in town

Euro-zone leaders also agreed on the so-called 'Euro Plus Pact' – formerly known as 'Pact for Competitiveness' or 'Pact for the Euro' – which aims to strengthen the economic pillar of EMU by committing euro-zone countries to closer economic coordination in order to improve competitiveness, foster employment, contribute further to the sustainability of public finances, and reinforce financial stability.

Member States which have not (yet) joined the common currency were invited to participate on a voluntary basis, and six countries – Bulgaria, Denmark, Latvia, Lithuania, Poland, and Romania – decided to do so immediately. The term 'Plus' was, according to President Van Rompuy, added to the name to indicate both that euro-zone countries have committed themselves to a higher degree of economic coordination and that the Pact is also open to Member States which have not (yet) adopted the euro.

The Pact focuses on areas that fall (predominantly) under national competence and are key to increasing competitiveness and avoiding harmful imbalances. It calls on participating states to: (1) review their wage-setting arrangements; (2) limit public-sector wage increases; (3) open up sheltered sectors; (4) improve education systems and promote R&D; (5) improve the business environment (particularly for SMEs); (6) give attention to labour-market reforms to promote 'flexicurity'; (7) support lifelong learning; (8) promote tax reform by e.g. lowering taxes on labour; (9) align pension systems to demographic developments; (10) develop a common corporate tax base; and (11) include some form of a 'debt brake' into national fiscal rules. Member States also commit to consult their partners on major economic reforms with potential spill-over effects before they are adopted.

The Pact, prepared jointly by officials working for the European Council President and the Commission, includes many elements of the original 'Pact for Competitiveness', although it is less strict than the German version. But the compromises offered and the concessions made persuaded those who had been initially highly critical to sign up to it. Most leaders were able to claim some sort of victory: the Germans and the French got their Pact, and others got rid of certain 'critical provisions'.

The Pact has been heavily criticized for a number of reasons, but the two most important relate to the high degree of 'flexibility' when it comes to enforcing it, and to its intergovernmental character.

The Pact is based on an agreement between Heads of State or Government without any specific enforcement procedures. The original German proposal had raised the possibility of introducing sanctions, but this is not mentioned in the Euro Plus Pact. Member States have also been given more freedom in how they interpret the agreement.

Euro countries are supposed to agree at the highest level on a set of concrete actions to be achieved within 12 months. The ball is now in the Member States' court. A number of countries have already announced first commitments, and all commitments will be included in the Stability or Convergence Programmes and National Reform Programmes to be submitted in April and assessed at the June European Council. However, "the selection of the specific policy measures to be implemented will remain the responsibility of each country". The Pact's 'flexibility' is also evident in the provision that the pursuit of common objectives – set jointly by the Heads of State or Government – will be pursued by the participating Member States "with their own policy-mix, taking into account their specific challenges".

The 'deal' on the Pact has proven once again that Member States are not ready to surrender national sovereignty in key areas such as pensions, labour and wage policy, or taxation, as an additional transfer of competences in these areas would limit national prerogatives in the last remaining bastions of state sovereignty. It is thus no surprise that national policy-makers – even those tied together by a common currency – opt for loose coordination rather than genuine harmonisation and integration of national economic policies. 'Muddling through' has long been the EU's dominant mantra and this is unlikely to change in the near future, as long as policy-makers and citizens are not ready to accept the consequences of a *gouvernement économique* worthy of the name.

It would, however, be too easy – and a mistake – to disregard the Pact's potential by simply comparing it to previous, rather unsuccessful, attempts at loose economic coordination between Member States (including the Lisbon Strategy or the Open Method of Coordination), for one main reason. The crisis has underlined the high degree of interdependence between Member States, particularly within the euro zone, where decisions or developments in one country can not only negatively affect others but even destabilise the common currency's stability.

The experience of the sovereign debt crisis is thus likely to increase the 'level of ownership' in the Member States of instruments like the Euro Plus Pact – or other instruments and mechanisms based on rather loose forms of economic coordination like Europe 2020 or the European semester (see also below). One can expect euro-zone countries – especially those called on to bail out stumbling partners – to monitor developments in other EU countries much more carefully than in the past. This could foster the process of 'naming, shaming and blaming', which in return would increase the likelihood that instruments such as the Euro Plus Pact can make a difference. A higher level of ownership by Member States should also enable the Commission to produce more concrete, timely, objective and revealing assessments than in the past.

Critics also point to the fact that the Pact is intergovernmental and does not follow the traditional 'Community method', which attributes a strong role to both the Commission and the European Parliament. This is a valid criticism. However, a number of important considerations should not be overlooked. First, the Commission's involvement is guaranteed by the fact that the implementation of commitments and progress will be monitored annually by the Heads of State or Government of the euro zone and other participating countries on the basis of a report prepared by the Brussels executive. Second, the Commission can 'use' the Pact to develop legislative proposals designed to achieve certain objectives included in its framework.

There is already a first example of this happening. Taking advantage of the political momentum created by the discussions on the new Pact, the Commission tabled a draft legislative proposal on 16 March which foresees the development of a Common Consolidated Corporate Tax Base (CCCTB) – an idea mentioned in both the original and final version of the Pact. This is not a new idea (it was first raised in 2001 in a Commission communication), but progress has been slow due to Member States' reluctance to allow the Commission and other EU countries to encroach on their national sovereignty. The new Pact provides the Commission with an opportunity to launch a second attempt, with a strong chance that it will succeed this time around – even if this is only possible, in the end, by using the enhanced cooperation instrument if some countries are not ready to go along with it.

'Six pack' – Stability and Growth Pact III and macro-economic surveillance

In their conclusions, EU leaders asked the Council to reach an agreement with the European Parliament on the package of six legislative proposals aimed at enhancing economic governance in the EU unveiled by the Commission in September 2010. These proposals are in line with the recommendations made by the Task Force on economic governance chaired by President Van Rompuy, which were endorsed by the European Council in October 2010.

Stability and Growth Pact III

Four of the proposals included in the 'six pack' – as it is known in Brussels jargon – relate to reform of the Stability and Growth Pact (SGP). They aim to enhance the surveillance of fiscal policies and apply enforcement measures more consistently and at an earlier stage. The implementation of these proposals would create a third version of the SGP. The 'SGP III' would be a tighter version of the original Pact set up in 1997, which was watered down in 2005 after Paris and Berlin refused to abide by the rules. The proposals include three key innovations designed to improve fiscal discipline:

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

- *More sanctions:* The draft legislation suggests a wider range of sanctions and measures in both the preventive and corrective arms of the SGP. The list of potential sanctions includes both reputational and financial measures:

  (i) *Reputational sanctions:* When a Member State does not implement a Council recommendation, the Council and the Eurogroup will formally report to the European Council. When a Member State is subject to enhanced surveillance, the Commission will have the right to conduct on-site monitoring missions.

  (ii) *Financial sanctions:* The draft legislation suggests also new financial enforcement measures, including interest-bearing deposits, non-interest bearing deposits and fines. These measures will, in the first instance, only be introduced for euro-zone countries (on the basis of Article 136 TFEU).

- *Greater 'automaticity':* The Commission's proposals foresee that the decision-making procedure for the new financial enforcement measures should ensure a higher degree of 'automaticity' through the introduction of the so-called 'reverse majority rule'. These decisions should be based on Commission recommendations, which will be considered adopted unless a qualified majority of Member States votes against the recommendation in the Council within a certain deadline. The reverse majority rule is, however, not supposed to be applied to later-stage sanctions; i.e. increased fines for persistent lack of compliance. In these cases, the usual Council voting rules will continue to apply. In general, the concrete level of automaticity is not clear yet, as the detailed practicalities of the new decision-making rules still need to be defined in the course of the legislative process, involving not only the Commission and the Council but also the Parliament, which is an outspoken advocate of more quasi-automatic sanctions.

It is too early to deliver a verdict on the effectiveness of SGP III, as its true value will only become apparent in practice. But it has already raised a number of concerns. First, the new rules rely solely on sanctions to ensure greater fiscal discipline. Calls for incentives to 'motivate' governments to abide by the rules have been disregarded. Second, one cannot be sure that the new sanctions will be applied in practice. None of the sanctions foreseen since the first version of the SGP have ever been used and there are doubts that greater 'automaticity' will work: it is by no means clear that the Commission will be independent and politically strong enough to recommend financial enforcement measures. Third, there is a question mark over whether it makes sense to fine a country in financial trouble, as this would not only worsen the fiscal situation of the country concerned, but might also provoke counter-productive anti-EU sentiment, which could undermine the country's readiness and ability to return to the path of fiscal virtue. Finally, there are reasons to doubt whether the new rules will apply equally to all EU countries whatever their economic and political weight, given that the SGP has already been less strictly applied for France and Germany than for others.

Macro-economic surveillance

The two other legislative proposals in the 'six pack' set up a new surveillance system for macro-economic imbalances. The European sovereign debt crisis has demonstrated that compliance with the SGP is important, but by no means sufficient. The Commission – and the Task Force – thus rightly proposed an annual assessment of the risks of macro-economic imbalances and vulnerabilities, given that persistent and large imbalances and divergences in competitiveness, particularly among euro-zone countries, are a major threat to the functioning of EMU.

The new surveillance framework is based on a two-stage approach:

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

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

The introduction of the macro-economic surveillance mechanism has been portrayed as a major innovation. In theory this is true. However, there are a number of reasons to question whether or to what extent the new mechanism will succeed in practice.

First, will the early warning system really detect imbalances at an early stage? Experience has shown that imbalances and vulnerabilities are in many cases not detected early on, which makes it very difficult to reverse developments already under way.

Second, the proposals on the table do not give concrete details of all the indicators that will be used to draw up the competitiveness scoreboard and the surveillance mechanism risks becoming a very subjective exercise open to a high level of discretion.

Third, even if one assumes that imbalances and vulnerabilities are detected, the Commission and Council's ability to 'persuade' the respective Member State to counter them cannot be taken for granted, judging from past experience: would, for example, Greece have prevented wage increases beyond the increase of productivity; would Germany have refrained from restrictive wage increases; or would Spain or Ireland have imposed high real-estate taxes to avoid a housing sector bubble? The answers to these questions are far from certain and there is reason to doubt that the Commission will (always) have the political courage and clout to address these kind of macro-economic imbalances in the future – especially if corrective measures involve bigger Member States.

The European Council welcomed the agreement reached at the March 15 Ecofin Council on a general approach to the package of legislative measures. This enables the Hungarian Presidency to start negotiations with the Parliament aimed at reaching an overall agreement in June 2011. However, the Council will face over 2,000 amendments from MEPs when they start negotiations in April.

A new round of stress tests – will they be more convincing?

EU leaders underlined the importance of the new round of bank stress tests being carried out by the newly-created London-based European Banking Authority (EBA) between March and June. But there are already doubts about whether the 2011 tests will be tougher than those conducted in 2010, which were widely condemned as a 'farce' after only seven of the 91 banks scrutinised failed and all the Irish banks passed, only to require enormous capital injections by the end of the year.

The EBA insists that the new round of tests will be tougher. The objective is to assess the resilience of the EU banking system, and the solvency of individual institutions, to hypothetical stress events. The adverse scenario, designed by the ECB, is tougher than the previous one, as it assumes a fall in euro-area GDP of 2% in both 2011 and 2012, compared with a 0.9% and 2.0% drop in 2010 and

2011 assumed last time around. More concretely, the adverse scenario assumes that: (i) euro-area long-term interest rates go up by 75 basis points, and by 66 basis points in the EU; (ii) stock prices fall by an average of 15% in the euro area, leading to an average 14% shock for the EU; (iii) house prices in the euro area fall by 2.7% in 2011 and by 9.7% in 2012, and in the EU by 3.8% in 2011 and 11.6% in 2012; (iv) short-term inter-bank rates increase by 125 basis points; (v) a negative shock reduces consumption by 1.4% and investments by 4.5% in the euro area, and 0.8% and 2.5% for the rest of the EU; and (vi) the US dollar depreciates by close to 4%.

Market players are sceptical as to whether the new tests will restore confidence in the European banking system, mainly because the adverse scenario does not consider the effects of an EU country defaulting on its debt and the potential repercussions on bank balance sheets throughout Europe.

However, despite this valid criticism, one can at least assume that the new round of stress tests will produce a more objective 'health assessment' of the European banking sector. This is one reason why EBA chairman Andrea Enria has urged EU governments to put in place emergency bank recapitalisation mechanisms within the next three months, so that each country will be in a position to correct capital shortfalls if some banks failed the stress tests.

European semester – an infant's first steps

The March European Council officially concluded the first phase of the so-called European semester, which aims to enhance *ex-ante* economic policy coordination. Under this new system, introduced in 2010 as one pillar of the new economic governance model, surveillance takes place in the first half of the year before national budgets and economic reform programs are finalised.

The start of the 2011 European semester was marked by the Commission's Annual Growth Survey, published on 12 January, which highlighted ten actions for the EU in 2011/12 including measures to implement rigorous fiscal consolidation, correct macro-economic imbalances, ensure stability of the financial sector, reform pension systems, get the unemployed back to work, balance security and flexibility, tap the potential of the Single Market, attract private capital to finance growth, and create cost-effective access to energy.

The 24-25 March Summit endorsed a number of priorities in the framework of the European semester, and Member States are supposed to present their national commitments in their Stability or Convergence Programmes and their National Reform Programmes for 2011/12 by mid-April. Subsequently, the Commission will propose country-specific opinions and recommendations in good time before their adoption before the June European Council, which the Member States should take into account when preparing their budgets for 2012. Member States are also called upon to present a "multi-annual consolidation plan" including specific deficit, revenue and expenditure targets, the strategy envisaged to reach these targets, and a timeline for its implementation.

Fiscal consolidation efforts are supposed to be complemented by "growth-enhancing structural reforms" and Member States are asked to implement measures aimed at making work more attractive, helping the unemployed to get back to work, combating poverty and promoting social inclusion, investing in education and training, balancing security and flexibility, reforming pension systems, attracting private capital to finance growth, boosting research and innovation, allowing cost-effective access to energy and stepping up energy efficiency policies.

The objectives, priorities, reforms, and measures mentioned in the context of the European semester make sense and are (probably) worthwhile. However, as with the Euro Plus Pact, there are some reasons to doubt that all these interesting ideas and recommendations will be effectively implemented at the national level.

But there is also another, more fundamental question. The plethora of instruments and labels – including the European semester, the Euro Plus Pact, or Europe 2020 – created in an attempt to enhance European economic governance, are causing a great deal of confusion. This is probably one reason why an increasing number of observers doubt the added value of one or the other innovation, and as many of the instrument overlap, it is becoming increasingly difficult for interested citizens, national policy-makers and the media to understand and follow all these procedures and programmes, which in turn limits the ability of the 'fourth estate', in particular, to publicly name and shame their own governments if they do not fulfil the commitments they made in Brussels.

The new European economic governance model – some thoughts and many more questions

Beyond the specific evaluation of the new elements of the enhanced model of European economic governance, there is the more fundamental question of whether the reforms put in place since 2010 will, in the end, provide the right medicine to cure the patient.

In the last 15 months, the EU – and especially the countries of the euro zone – has gone through a major crisis, which at times stretched the Union, the Member States and the stability of the common currency to the limit. The EU has not yet mastered the crisis. However, much has been achieved since the Greek crisis erupted in early 2010, when the EU had no effective means to meet the challenge.

Market pressures and severe problems in a number of euro-zone countries have forced the EU and its members to make every effort necessary to strengthen economic governance. More work lies ahead, but this European Council added almost all the final pieces to a puzzle which will significantly strengthen the economic pillar of EMU. Taken together, the individual innovations – which are by no means perfect – constitute a quantum leap, which hopefully over time will contribute to re-establishing financial stability, averting similar crises in future and strengthening the credibility of both the euro and the EU inside and outside Europe.

However, it would be premature to deliver a final verdict. The reforms still need to be successfully implemented and tested in practice, and Member States will have to prove their determination both on the European and national level. But what are the major unanswered questions and the severest challenges that lie ahead in this unprecedented 'experiment'? The following three seem particularly important.

Social and political dominos

There is a real danger that we might witness increasing crisis fatigue in both the weaker and stronger EU countries. How many further concessions will the weakest countries be able to make? What happens if the economies of Greece, Ireland or Portugal suffer a slow death? Or if their governments are unable to impose further austerity measures and implement additional reforms? Will the strongest then continue to provide financial assistance through the rescue mechanisms? Are Austrians, Dutch, Finns, or Germans really likely to be ready to provide more support? And what could all this mean for the social and political climate within and between Member States?

On both sides, an increasing national focus and a rise in populism as well as anti-EU sentiment are evident in all parts of society. The EU is more and more perceived as a problem. The weakest hold that the EU, and especially core countries in the euro zone, are imposing too much on them and asking too much from them. The strongest fear that they will have to pay for the self-inflicted problems on Europe's periphery and that the EU will turn into a 'transfer union'.

Obviously, the truth is much more complex. However, the different perceptions and understandings of the crisis create an explosive mixture, which can lead to social unrest and political turbulence in, and in the worst case even between, EU countries. So the EU may have stopped the economic domino effect at the borders of Portugal, but the social and political domino effects – which usually come with a certain time lag – might be just as great a cause for concern.

The insolvency dilemma

The new economic governance model has not yet convincingly answered the following key question: can euro-zone countries in the periphery of Europe cope with a level of public debt well beyond 100% of their GDP, when this means that they have to use a very large proportion of their state revenues to pay back debts and interest in a time of limited economic growth? There is now a strong conviction throughout the EU that Member States have to reduce not only their public deficits but also their levels of public debt. But will countries like Greece, Ireland or Portugal be able to stop the increase and then reduce the high levels of debt quickly enough to regain access to the bond markets under viable lending conditions within a few years? Or will these countries be forced to find other ways to reduce public debt levels?

While the ESM opens up the theoretical possibility for a debt restructuring within the euro zone, will this procedure – which includes an "involvement of the private sector" – provide an adequate and timely answer to current debt challenges faced by countries like Greece, Ireland or Portugal? Or is it not rather an insolvency mechanism designed for a next crisis after 2013 – which will hopefully be avoided by the preventive elements of the new governance model?

Are there ways to restructure the current debt of the weakest euro-zone countries? Should these Member States quickly engage in a collective 'big-bang insolvency' as, for example, suggested by Daniel Gros? Would this not mean significant losses not only for commercial banks but also for the ECB, as it holds more than €77 billion worth of bonds of the countries concerned? Or are those right who argue that it is highly unlikely that a euro-zone government will ever be pushed into sovereign default because a restructuring of public debt would be uncontrollable in a currency area including highly-developed and highly-interdependent countries? Debt restructuring in one euro-zone country would, they argue, spark uncontrollable chain reactions, with devastating effects on other euro members.

Is there a third option? An alternative combining a whole set of different instruments might include: (i) a very mild and orderly form of restructuring, which excludes a 'haircut' but includes an extension of maturities and a substantial decrease in interest rates; (ii) a buy-back of bonds on the secondary markets below the nominal value of debt before the ESM's entry into force; (iii) a reduction of debt levels through large privatisation programmes; (iv) the stimulation of growth through infrastructure projects in Europe's periphery financed by project bonds, as part of a 'mini-Marshall Plan' from which both the North and the South – including Europe's neighbours in the southern Mediterranean – could benefit; and (v) maybe even – although this seems politically highly unlikely – the introduction of Eurobonds covering a proportion of the EU's overall debt (around 40%).

Restructuring of the banking sector

One must also ask whether the EU and its members are fighting the right crisis. Could it be that they are concentrating too much on reducing or managing the effects of high deficits and debt levels, and on measures aimed at increasing competitiveness and economic coordination, while the real challenge still lies where the global crisis started; i.e. in the banking sector? Fiscal sustainability and economic convergence must remain high on the agenda, but will the EU be able to exit from the crisis while the banking system remains highly fragile due to an undercapitalised and oversized banking sector?

A restructuring of the banking sector is a 'hot potato' which nobody dares to touch for a number of reasons. First, the financial sector still wields significant power and influence, even in the wake of the crisis sparked by the fall of Lehman Brothers in September 2008. Second, policy-makers and regulators fear unintended and unmanageable consequences of a restructuring of the sector. Third, national regulators are anxious to protect their own banks and their own banking sector. Finally, a reform of the banking sector which includes a recapitalisation and (temporary) nationalisation of a number of banks would be enormously costly – and would be very difficult for politicians to sell to taxpayers.

However, the EU might face another, maybe even bigger crisis if national authorities and regulators do not act to defuse this hidden time bomb. It remains to be seen whether the second round of bank stress tests will deliver more credible results and thus trigger an adequate response in those countries where banks fail the test. If not, we might require another even stricter third round of tests, but the clock is ticking...

The Libyan crisis – signs of (dis)unity and potential effects on EU foreign policy

EU leaders tried to use the Summit to display – to the Gaddafi regime, to the outside world and to their own voters – their unity and determination in dealing with the Libyan crisis. However, rifts between key Member States, especially Paris and Berlin, could not be concealed by the Summit Conclusions.

President Sarkozy has been the leading European advocate of air strikes against the Gaddafi regime, which began on 19 March two days after the adoption of the United Nations Security Council resolution 1973 authorising the use of force to impose a 'no-fly zone' over Libya. Germany, on the other hand, strongly supports civilian measures against the Gaddafi regime but opposes military action, and abstained from the vote in the Security Council along with Brazil, China, India, and Russia – sparking a heated debate in Germany about the potential impact of its decision on Berlin's position in European and international affairs.

The European Council once again condemned the violent and brutal repression which the Gaddafi regime continues to inflict upon its own citizens and reiterated its call for Colonel Gaddafi to relinquish power immediately, so that the country can embark on the transition to democracy. Despite their differences over the 'no-fly zone', EU leaders declared that military actions in Libya had "significantly contributed to protect civilians" and "helped to save the lives of civilians". They also agreed to initiate further sanctions, including measures to ensure that oil and gas revenues stop reaching the regime (although the technical arrangements for implementing these additional sanctions still need to be determined), building on the decision taken by Member States some weeks ago to bar members of the regime from entering the EU and to freeze a set of Libyan assets.

It is too early to predict the mid- to long-term effects of the current events on EU foreign policy. The situation in Libya and in the rest of the region is enormously volatile, and much will depend on developments on the ground. If the enforcement of the no-fly zone – which effectively is not 'limited' to clearing the skies over Libya but also involves operations going beyond that – succeeds, and the rebels prevail in the end, champions of this approach will claim they have been vindicated. But if the Gaddafi regime fights back and if the operation drags on for weeks or maybe even months, the *ex-post* assessment will obviously be very different.

However, it is already clear that the current disunity within the EU (and in NATO) will have a substantial impact on the Union's foreign, security and defence policy. Differences over key foreign policy developments have pushed the EU to its limits in the past, but even after negative experiences as with the Balkans in the 1990s or Iraq in the early 2000s, the Union demonstrated that it was eventually capable of drawing the right conclusions – and one can only hope that this will again be the case this time.

But it is not only internal disunity within Europe which is likely to have a long-term impact. Crucially, and perhaps more significantly, Washington is now demonstrating that it is ready and willing to accept – and is even pushing – for a stronger European role and engagement on issues of global significance. It remains to be seen whether Europeans will be ready and able to rise to this challenge; the Libyan case may provide a first, albeit very preliminary, assessment of this.

Turning back to the situation in Libya and in the wider region, there are some positive signs coming from Egypt and Tunisia – and the European Council explicitly expressed its satisfaction with the smooth conduct of the constitutional referendum in Egypt. However, they also expressed their "utmost concern" at the escalation of violence and the use of force against demonstrators in Bahrain, Syria, and Yemen.

The EU – and others in the 'old West' and in the emerging world – will have to continuously prove their ability to respond to concrete developments in the region as they unfold. There is no one-size-fits-all recipe and no quick solutions to the challenges ahead. Europeans are in many ways sending out a message to Arab leaders and Arab citizens that the 'old continent' is ready to engage actively in the region, but there is always a danger that Europe might overburden itself and/or be seen as interfering 'too much' in its southern neighbourhood. That is why it is so important for the EU and its members to listen carefully to what its neighbours ask of them, because it will be they who will determine their own future – not Europe or any other outside player.

With regard to the region as a whole, the European Council declared that work on developing a new 'partnership for democracy and shared prosperity' with the region – founded on deeper economic integration, broader market access and closer political cooperation – should be taken forward rapidly. More specifically, EU leaders called for a €1 billion increase in the ceiling on European Investment Bank (EIB) operations for Mediterranean countries undertaking political reforms (without reducing operations in Eastern Europe), and asked the European Bank for Reconstruction and Development (EBRD) shareholders to extend its activities to countries in the Southern neighbourhood.

The Japanese catastrophe and nuclear stress tests

Following the devastating earthquake and tsunami that struck Japan on 11 March, and the nuclear disaster in Fukushima, EU leaders expressed their solidarity with the people and government of Japan, and their deepest condolences for the large-scale loss of life.

In more concrete terms, and in response to a request from the Japanese government, the EU is mobilising relief supplies for the affected population and stands ready to provide further support if requested. The European Council also commended the swift and decisive action taken by the Japanese authorities in response to 'disorder' on the financial markets, welcomed the action taken by the G7 on the yen, and said it stood ready to cooperate fully with Japan to address the economic and financial consequences of these events, including in the framework of the G8 and G20.

The EU's readiness to support Japan is to a large degree motivated by fears that a slowdown in the Japanese economy might have a knock-on effect in South-East Asia and eventually even on the world economy. This could have a destabilising impact on Europe's still very fragile return to growth and financial stability.

The ongoing nuclear disaster in the Fukushima power plant has also fuelled a new debate about the future of nuclear energy and about nuclear safety in the EU and on its borders. EU leaders declared that the Union must "draw the lessons" from the events in Japan, with President Van Rompuy saying that the issue of nuclear safety was now a "top priority".

Leaders agreed that all EU nuclear plants should be reviewed on the basis of a "comprehensive and transparent risk and safety assessment". President Barroso insisted that these 'stress tests', which will be conducted by independent national authorities and through peer review, must be done on the basis of "clear and transparent criteria". The Commission was asked by the European Council to work with the European Nuclear Safety Regulatory Group (ENSREG), an expert body composed of senior officials from national authorities, and all other relevant bodies and authorities to develop the modalities of these safety assessments. The results of the voluntary stress tests on 143 nuclear plants in 14 Member States will be made public and President Barroso said the Commission's role was essential "to ensure the credibility of this exercise". EU leaders have also called on neighbouring states, including Ukraine, Belarus or Russia, to carry out similar stress tests.

The European Council will assess the initial findings by the end of 2011 on the basis of a report by the Commission. There was no decision on how to proceed if some nuclear plants fail the tests, but it is clear that any decisions on plant closures would have to be taken by national authorities at Member State level, not by the EU. Austrian Chancellor Werner Faymann and President Sarkozy said explicitly that plants which fail the stress tests should be shut down, but Chancellor Merkel was more cautious, stating that the possibility of upgrading certain plants should not be excluded. However, countries in Eastern Europe have warned that such upgrades could put too great a strain on already overstretched public finances.

There are some who argue that publishing the results of the stress tests could increase the pressure on operators and governments to take whatever action is necessary, but others – most notably environmental NGOs – have expressed doubts, arguing that the stress tests are merely a 'placebo' designed to allay public concerns and buy time for the nuclear lobby.

Janis A. Emmanouilidis is a Senior Policy Analyst at the European Policy Centre.