EUROPEAN POLICY CENTRE

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Post-Summit Analysis

All eyes on Greece – the EU in crisis mode, again!

Summary

As so often in the past 18 months, an EU Summit, which was meant to focus on other issues, was overshadowed by a dramatic escalation of the euro-zone crisis, following the political turmoil in Greece. This EPC analysis by Janis A. Emmanouilidis warns that there is no 'silver bullet' to resolve the crisis, and that EU leaders will have to choose between "politically very painful and economically very costly" alternatives. But it calls for a bolder approach and for greater honesty from EU leaders about what needs to be done, and why. It also assesses the outcome of the discussions on the first European semester and the economic governance package, as well as migration and the free movement of people.

Full report

The EU Summit on 23-24 June 2011 concentrated on six major issues: the first day focused on recent developments in the euro crisis and the situation in Greece, on the conclusion of the first European semester and on fine-tuning the comprehensive economic governance package agreed in March. The second day was largely devoted to migration and the free movement of people, but also considered the Union's response to developments in the Arab world and Croatia's EU accession.

Political turmoil in Greece

European Council President Herman Van Rompuy had originally intended the June meeting of heads of state and government to focus on issues related to migration. But as so often in the past 18 months, the Summit was overshadowed by a dramatic escalation of the euro-zone crisis.

After the agreement on a comprehensive economic governance package at the March Summit, there had been some cautious optimism that the crisis could finally be contained. But these hopes evaporated in the run-up to the June meeting, with the deterioration of the political and socio-economic situation in Greece reviving fears that the crisis could further deepen and spread well beyond the borders of Portugal, reaching Spain or maybe even Italy and Belgium, with major consequences for the common currency and eventually also for the European integration process.

Fears that the negotiations between the Greek government and the troika – the European Commission, International Monetary Fund (IMF) and European Central Bank (ECB) – might fail, uncertainties following the arrest of IMF Managing Director Dominique Strauss-Kahn, unfounded rumours that Greece had decided to leave the euro zone, speculation about what was discussed at a 'secret meeting' of finance ministers and ECB President Jean-Claude Trichet in Luxembourg, warnings from the IMF that Greece's economic recovery programme risked being derailed unless the government accelerated fiscal reforms, an increasing awareness of the need for a second very substantial rescue package for Greece, and continuous debates about a restructuring of Greek debt – all of this contributed to a further escalation of the crisis, which reached another climax in the week before the EU Summit with major political turmoil in Athens.

Prime Minister George Papandreou's government tumbled as support drained away in its own ranks and among citizens. In the week before the Summit, Greece witnessed vast – mostly peaceful – demonstrations on the streets of Athens and other major cities fuelled by increasing frustration, despair and anger over additional austerity packages, tax increases and rising (youth) unemployment. Speculation about a grand coalition between Papandreou's socialist PASOK and the centre-right conservative New Democracy led by Antonis Samaras came to nought; instead, Papandreou reshuffled his government, appointing Evangelos Venizelos – a key party opponent and vocal critic of the memorandum of understanding between Greece and the troika – as finance minister.

The political chaos in Greece increased fears in Europe and beyond that the country might become a 'second Lehman Brothers': that Athens would be cut off from EU-IMF loans and forced into default by mid-July, provoking an uncontrolled chain reaction with enormous repercussions not only for Greece and Europe, but maybe even for the global financial system and world economy.

The reshuffle succeeded in stabilising the government, at least temporarily, and Papandreou survived a vote of confidence with the support of all 155 PASOK MPs just two days before the Summit. This provided some relief in Brussels and other EU capitals, but the situation remained fragile as a new €28 billion package of fiscal measures and a €50 billion sell-off of public assets agreed between the government and the troika required the Greek parliament's approval in the week after the Summit. The IMF and EU partners expressed their readiness to support Greece, but also increased the pressure on Athens by threatening not to disburse the fifth €12-billion tranche of the €110 billion rescue package if the agreed measures were not endorsed by the parliament.

Manoeuvring between carrots and sticks

Against this backdrop, it was no surprise that the Greek situation dominated the first day of the Summit. As a sign of support, the European Council Conclusions heralded the "considerable progress" achieved over the last year and welcomed the government's "continued strong commitment" to implementing the adjustment programme.

EU leaders called on the Greek authorities to continue implementing the necessary measures with resolve to put the country on a sustainable path. More specifically, they stressed that the new comprehensive package of fiscal adjustments and reforms agreed between Greece and the troika must be adopted by the parliament "as a matter of urgency in the coming days", with the decision on releasing the fifth tranche scheduled to be taken after the Greek parliament vote on 29/30 June, at a special meeting of euro-zone finance ministers on July 3.

EU governments and officials warned that there was no contingency plan if the Greek parliament did not approve the necessary measures. The fact that Papandreou had survived the vote of confidence made most political observers more optimistic that the new government would be able to push the package through parliament, but this was by no means certain, especially after two PASOK deputies declared that they would vote against it, reducing an already slim majority to just two votes.

EU leaders also issued another strong appeal to the Greek government and opposition to reach a national consensus on the austerity and privatisation programme, calling on all political parties to "support the programme's main objectives and key policy measures", and adding that "given the length, magnitude and nature of required reforms in Greece, national unity is a prerequisite for success".

However, opposition leader Antonis Samaras refused to cave in to the very strong pressure from various EU leaders and fellow conservative politicians from all over Europe, insisting that his party would not support the measures, raising fresh doubts about Greece's ability to deliver results. Mr Samaras argued that he would not support "the same kind of medicine for someone who is dying from that medicine". Instead, motivated by recent opinion polls suggesting that New Democracy could win a majority, he called for elections. His decision not to support the adjustment programme was met with utter incomprehension across the EU, particularly as the opposition in Ireland and Portugal had supported the fiscal measures and reforms in their countries. However, despite this vocal criticism, most observers assumed that the disbursement of funds in July would not be called into question if the Greek opposition voted against the measures, as long as an overall parliamentary majority was secured.

Private-sector involvement – 'imposing' voluntary support

In the months before the Summit, it became obvious that Greece would require a second major rescue package because it will not be able to return to financial markets in 2012 when the first EU-IMF package runs out, with forecasts suggesting that Athens will require €80-100 billion worth of additional loans to cover its financial needs between 2012-14.

The IMF has explicitly asked Europeans for an assurance that they will continue to support Greece, arguing that the Fund would not be able to provide further lending to Athens if it does not have guaranteed finance for the next 12 months, thus putting pressure on euro-zone members to indicate that they are in principle ready to provide further assistance in the framework of a second rescue package.

The most contentious issue in relation to this – the potential involvement of the private sector – was discussed over dinner at the Summit. Germany, strongly supported by the Netherlands and Finland, has insisted that private investors should be involved in any new package. Facing growing public criticism and opposition in the Bundestag, the government had reassured MPs that any additional assistance would involve private bondholders. Finance Minister Wolfgang Schäuble wrote to other EU Finance Ministers, ECB President Jean-Claude Trichet, Commissioner Olli Rehn and the IMF calling for additional aid to be made available to Greece, but also suggesting that private creditors should swap all their Greek sovereign bonds for new ones with extended seven-year maturities.

The ECB, the Commission and a number of EU governments were adamantly opposed to this. The ECB warned of the destabilising effects of involving private investors, which could lead to a 'credit event', causing market panic and major instabilities in the financial sector. Central bankers also indicated that the ECB would no longer accept Greek state bonds as collateral, cutting its banks off from much needed liquidity and thereby destabilising the country's entire financial sector.

The ECB also argued that the plan put forward by Mr Schäuble could not be construed as a voluntary restructuring and credit agencies would thus consider the involvement of private creditors as a default, causing major instabilities in the European and maybe even global financial sector. There are widespread fears that even 'soft' restructuring would provoke a credit event, triggering a request for payment by the holders of Credit Default Swaps (CDS). The ECB itself is also eager to avoid a massive restructuring of Greek debt because it acquired Greek sovereign bonds worth close to €50 billion up until March 2011 in order to stabilise markets – a move strongly criticised both within and outside its ranks.

The ECB's position on private sector involvement was supported by a Commission paper arguing that a 'less voluntary' option for private bondholders would be assessed as a default, pushing the Greek banking system to the wall; and Eurogroup President Jean-Claude Juncker warned that "we are playing with fire" and that a default might not only affect Portugal and Ireland, but also Belgium and Italy, maybe even Spain. Athens feared that a restructuring of its sovereign debt could cut it off from financial markets for a long time as markets might assume that a soft form of restructuring would eventually be followed by a more severe haircut.

Paris had been particularly sceptical about restructuring Greek debt as French banks are still highly exposed to Greek sovereign and private debt. According to estimates, BNP Paribas, Société Générale, Crédit Agricole (which owns one of the biggest Greek banks) and Dexia hold Greek sovereign bonds worth approximately €19 billion and private loans worth more than €40 billion. In comparison, the exposure of German private banks and insurance companies is smaller: around €13 billion in government bonds and €10 billion in private loans.

At a bilateral meeting in Berlin in the week before the Summit, German Chancellor Angela Merkel and French President Nicolas Sarkozy reached a compromise over the involvement of private bondholders, with Berlin agreeing that private investors should be involved on a purely voluntary basis, which should not be classified as a default and thus avoid a credit event. Both leaders indicated that bondholder involvement could be organised along the lines of the so-called Vienna Initiative of 2009, when Austrian banks agreed to roll over debts to struggling central and eastern European governments.

In the Greek case, private investors should agree to a voluntary debt swap in which private bondholders roll over their debt when their existing bonds mature between 2012-14 (or 2015). Merkel and Sarkozy also agreed that a solution should be found quickly and in agreement with the ECB, which seemed likely given that key figures at the ECB – including President Trichet and his successor Mario Draghi – had also spoken out in favour of a voluntary roll-over for debt due over the next three years.

Chancellor Merkel's concession was greeted positively in Brussels and in other EU capitals, but heavily criticised in her own coalition government and by the opposition. Aiming to appease critics, Merkel and other leading figures in the German government declared their determination to achieve a substantial and quantifiable contribution from private bondholders.

The final details of private-sector involvement still need to be worked out and it is impossible to quantify exactly how much a voluntary roll-over would contribute to filling Greece's financing gap, but there are hopes that it could amount to up to €30 billion of the approximately €120 billion required. What is certain, however, is that the impact of a voluntary roll-over will be smaller than originally proposed by Germany, as it will 'merely' involve bonds maturing in the next couple of years and not the overall debt held by bondholders, as originally foreseen by Schäuble.

In the week of the Summit, Belgian, Dutch, German, French, Italian and Spanish authorities began negotiations with representatives of the financial industry. First reactions suggest that major banks and insurance companies are ready to participate in a voluntary roll-over, although some have asked for incentives to secure their support (state guarantees, senior status). However, government officials claimed that it was in the financial sector's own interest to support this initiative anyway to avoid another major market disruption.

However, one key problem remains unresolved: the three major rating agencies – Fitch, Moody's, and Standard and Poor's – have indicated that they would consider a soft restructuring including even a voluntary roll-over as a credit event. This would lead to a (further) downgrading of Greece's credit rating, which in turn could trigger a decision to activate CDS, potentially forcing some banks into insolvency if they are faced with a multi-billion bill for selling protection on Greek CDS. The gross CDS exposure on Greece is estimated at €79 billion, and the decision on whether a roll-over triggers a credit default swap pay-out will have to be taken by a committee which meets under the auspices of the International Swaps and Derivatives Association (Isda) and includes ten banks and five investment funds. A majority of experts argue that it is highly likely that a roll-over along the lines of the Vienna Initiative would not trigger a credit event as it would not be binding on all bondholders.

To sum up, the current recipe for tackling the Greek and overall euro crisis buys time and foresees that Athens will receive continuous and additional support from its euro-zone partners and the IMF in 2011 and beyond, provided that Greece is ready and able to continue down the painful and difficult path towards fiscal consolidation and that private investors are involved in a large second rescue package in one way or another.

No silver bullet – but will the medicine work?

But will this medicine cure the patients – Greece, other EU countries at risk and the euro itself? The frank and honest answer is that nobody knows. Recent events have once again demonstrated the complexity of the situation, as Europe is still facing a systemic crisis, which threatens not only individual Member States but also the stability of the entire euro zone.

However, one thing became obvious in the days and weeks before the Summit: there are no 'easy solutions', no silver bullet. Under the current circumstances, EU leaders need to choose the best option from among a number of politically very painful and economically very costly alternatives.

The strengthening of European economic governance is a necessity and many significant reforms have been agreed or put in train over the last 15 months. The overall package aimed at strengthening the 'E' in EMU is a major leap forward: it is essential to calm the markets and to appease national policy-makers and populations, and, if implemented forcefully, could help to avoid similar crises in the future.

In an ideal world, the EU – and especially the euro-zone countries – should go even further. The introduction of euro bonds, the creation of a European finance ministry, the harmonisation of policies in areas such as taxation or social policy, a substantial increase in the EU budget, the creation of a 'Defence Union', and a number of politico-institutional reforms (including for example, the direct election of an EU President heading both the European Council and the European Commission) – all of this should be on Europe's wish list, and would lead to the creation of an economic and political union with a state-like quality able not only to solve the euro crisis but also to achieve the strategic objective of a global Europe capable of playing a key role in determining international political and economic developments in a highly dynamic global environment.

But let us be realistic: Member States – even the most integration 'friendly' – are not willing or able to take such a major qualitative leap. National elites (including governments, parliaments, political parties, and even constitutional courts) and most citizens are not ready to pool national sovereignty on such a scale. On the contrary, nationalism, parochialism, provincialism, populism and Euro-scepticism are on the rise, and 'muddling through' is likely to remain the Union's dominant mantra for the foreseeable future, especially given the increasing distrust between national capitals in times of multiple crises.

However, 'muddling through' can take different forms; the EU and its members can choose between a number of alternatives to cope with the crisis.

To begin with, one can exclude the option of Greece leaving the euro zone for two major reasons. First, exiting the common currency would not solve but rather increase the country's problems, so leaving EMU would be a major mistake for the Greeks and no one else can force them out of the door. Second, the departure of Greece or any other country from the euro would spark fears that others would eventually have to follow – far from calming the markets, instability would increase even further. The exit of a country from the common currency might even herald the beginning of the end for the euro and maybe even for the European project.

But what is the alternative? A number of very vocal economists and commentators have argued that Greece and other countries facing insolvency should default as quickly as possible, to allow for a substantial debt restructuring (haircut) aimed at restoring sustainable debt levels, increasing competitiveness, and stabilising the markets and the euro zone. Wasting time would – according to this logic – make things even worse.

From a purely economic point of view and in isolated cases of sovereign default, this might be a viable solution. However, in the current European context, it entails a number of major systemic risks. It seems very likely that sovereign default(s) would, in the current situation, lead to unforeseeable negative spill-overs. Financial markets and citizens in Greece and other peripheral countries might panic, and as long as financial institutions remain highly exposed and undercapitalised, a major run on the banks would definitely have uncontrollable effects on the Greek banking system and eventually maybe even other European countries.

Greek banks, which are highly exposed to their country's sovereign bonds, would have to bear major losses, and while euro-zone partners and the ECB might be able to stabilise the situation in Greece, the chances are high that a worsening of the Greek crisis would further aggravate the situation in Portugal and Ireland – also pushing them into default – and the crisis might spread even to Spain, Italy or Belgium, pushing them to ask for a rescue. This would not only overburden existing crisis mechanisms, but also push the ECB to its limits. A major default would also activate CDS, with unforeseeable consequences not only for European but also for global financial markets.

Put simply, as long as this systemic risk exists, 'core' members of the euro zone will have to continue supporting tumbling countries on Europe's periphery. Unlike in the early days of the sovereign debt crisis, EU leaders – and an increasing number of commentators – seem to have realised that there is no other option than to support their weaker euro-zone partners. This has been a bitter pill to swallow, but they had to do so, not out of solidarity but out of self-interest; and that is why euro-zone governments now even seem ready to agree to a second additional rescue package for Greece, despite all the opposition to this most of them face at home.

This recipe for solving the crisis is rational, but highly risky. The political and social situation in both the weaker and stronger euro-zone countries could deteriorate further and eventually spiral out of control – as is already happening in Greece, where public anger and opposition from those defending vested interests is making it increasingly difficult to impose further reforms, austerity and tax measures. This should not have come as a surprise: at some point, public acceptance of onerous reforms and major cuts in public spending was going to wear thin. The slow death of the Greek economy, falling standards of living, increasing unemployment, the loss of control over the country's economic policies, the massive privatisation of state assets, a discredited and overstrained political class, wounded national pride and increasing despair, anger and a deeply felt sense of injustice all add up to a potent and dangerous mix.

On the other side, the strongest euro-zone countries feel increasingly overburdened and betrayed, and fear that they will have to go on 'paying' for the self-inflicted problems on Europe's periphery and that the EU will eventually turn into a permanent transfer union in which the richest will have to continuously provide financial assistance to the weakest euro countries.

On both sides, there is an increasing national focus and a rise of populism profiting from growing anti-EU sentiment. The Union and the euro are increasingly perceived as problems and citizens as well as parts of the elites are challenging the current recipe for overcoming the crisis at both national and European level. This situation is not sustainable – so what to do? Three things seem key.

First, continuous in-depth reforms and targeted spending cuts in Greece are indispensable, not only to improve its economic and fiscal performance but also to secure continuous support from partner countries and the IMF. But Greece also needs a positive economic perspective: 'pain today for gains tomorrow' will make the current measures more acceptable. A conscious attempt to limit the immediate negative impacts of austerity (for example, by ring-fencing expenditure on economic infrastructure, health and education) as well as direct investment through the EU is needed. This is politically difficult, but the alternative is no better: is ongoing short-term support to prop up Greek public finances with increasingly reluctant populations really a feasible or desirable option?

Discussions about a 'mini-Marshall Plan'; the idea of speeding up access to EU funds already committed to Greece suggested by Juncker and Commission President José Manuel Barroso and partially endorsed during the Summit; Schäuble's proposal to invest in renewable energy sources on

Europe’s periphery; or the notion of setting up project bonds to co-finance major infrastructure projects – all these proposals point in the right direction.

A ‘New Deal’ concentrating on investment would increase the political feasibility of reforms, demonstrate solidarity, boost growth and employment in the weaker economies, reduce divergence in the euro zone and, in the end, calm the markets: even speculators take long-term growth potential and the political feasibility of reform into account. Such an approach would also make extra help more acceptable in the stronger economies: investing money would give them a real stake in achieving economic growth, and a return to growth in the weaker economies is indispensable to avoid Greece and other peripheral countries becoming buckets without a bottom.

Second, EU leaders and other political, economic and intellectual elites will have to tell their electorates and fellow citizens the truth and nothing but the truth: they will have to make clear that the stability of the euro must be preserved at all costs.

In the weaker countries, the governments and opposition will have to support and defend further reform and austerity measures, and explain that there is no viable alternative if these countries want to continue to profit from financial assistance from their EU partners and from the benefits of a stable currency.

In the stronger countries, governments must be honest and tell their publics that Europe’s periphery will require further assistance and at some point in time most of the debt will be held or guaranteed by euro-zone countries, the EFSF/ESM, the IMF and the ECB. If weaker countries do require a substantial restructuring of their debt (as most economist seem to think), institutional lenders and thus, in the end, taxpayers will have to bear most of the costs.

It will not be easy to convey and win acceptance for this truth. But unless they put all their cards on the table, EU leaders will not be able to defend their case and in the end risk public revolt, with dire consequences for current and future generations of Europeans.

Third, the EU and its members need to eliminate the systemic risks of the current crisis by concentrating on two major issues. First and foremost, European and national authorities and regulators will have to intensify their efforts to further stabilise a fragile and undercapitalised financial sector, which still remains at the heart of the crisis. In addition, and equally important, the EU and the IMF must succeed in some of the countries already receiving financial support to reduce the systemic risks linked to a potential default/restructuring of a country in the euro zone.

Member States have to convince markets that the recipe being followed is the right one and send a signal to countries lagging behind that financial assistance cannot be taken for granted forever. The governments, opposition and population in Greece, Ireland and Portugal should be aware that solidarity – even if it is motivated by self-interest – will at some point in time reach its limits. This point will be reached when the systemic risks of a sovereign default have been reduced to a minimum, when the stronger countries are convinced that they can stop providing assistance without risking a further deterioration and spreading of the crisis. Positive assessments of progress in Ireland and Portugal – testified by recent reports of the troika and judgements of the IMF – indicate that this moment might not be too far away.

Implementing and fine-tuning the economic governance package

The first day of the Summit not only dealt with the Greek crisis, but also with decisions on the implementation and fine-tuning of the comprehensive economic governance package prepared and endorsed over the past 15 months. EU leaders discussed the European semester and the Euro Plus Pact, endorsed both a reform of the European Financial Stability Facility (EFSF) and the treaty establishing a permanent European Stability Mechanism, and welcomed progress made on the legislative proposals known, in Brussels’ jargon, as the ‘six pack’.

European Semester/Euro Plus Pact – key next steps

The Summit marked the conclusion of the first European semester, introduced in 2010 as one of the key pillars of enhanced economic governance. Drawing on the lessons of the crisis, which highlighted the extent of economic interdependence, this new instrument aims to enhance *ex-ante* coordination of key economic policy priorities. Under this new system, surveillance takes place in the first half of the year before national budgets and economic reform programmes are finalised. The European semester also integrates the additional commitments made by the 23 countries participating in the Euro Plus Pact, including all 17 euro countries and six non-euro countries which opted to join the Pact voluntarily (Bulgaria, Denmark, Latvia, Lithuania, Poland, and Romania).

The first European semester started In January 2011 when the Commission published its Annual Growth Survey, outlining what it expected national economic policies to concentrate on in the coming period. EU leaders endorsed the Survey at the March European Council and by April, all 27 Member States had presented their national commitments in their Stability or Convergence Programmes (on public finances) and their National Reform Programmes (on structural reforms and growth-enhancing measures) for 2011/12. The Commission proposed country-specific opinions and recommendations on 7 June and these were officially endorsed by the European Council. Governments have now been asked to implement these plans over the next 12-18 months. Member States' progress in implementing the country-specific recommendations and their commitments under the Pact will be assessed by the European Council in March 2012 on the basis of the Commission's next Annual Growth Survey, due in January 2012. With respect to the Euro Plus Pact, heads of state and government indicated that they will return to some of its themes in December, before the launch of the next European semester.

During the Summit, EU leaders took stock of the EU's economic situation on the basis of a Commission report presented by President Barroso. At their joint press conference, both Van Rompuy and Barroso said there had been a "very free and open discussion" about the most important economic challenges facing the EU. President Barroso's presentation focused on the need to (1) continue fiscal consolidation; (2) fix the banking sector; (3) correct macroeconomic imbalances; (4) pursue pensions systems reform; (5) frontload growth; and (6) tackle the social impact of some of these reforms. All this sounds very familiar and persuasive, but question marks remain over whether the European semester and the Euro Plus Pact can push this long list of objectives forward.

The language used in the Summit Conclusions and the criticism voiced in the weeks before the European Council show that both new instruments need further improvement. With regard to the European semester, the Conclusions state that the new coordination framework "can become an effective governance method" and that the policies and measures presented by Member States "constitute a good starting point". With respect to the Euro Plus Pact, the Conclusions are even more explicit, arguing that the 100 separate measures presented by the 23 participating countries merely "constitute a good first step".

In more concrete terms, there are a number of problems and deficiencies that need to be overcome if the European semester and the Euro Plus Pact are to provide added value:

- *Procedural deficits:* To begin with, the European semester suffers from time constraints. In the early phase of the process, Member States do not have enough time to prepare and submit their budget and economic planning documents. National authorities have also complained that the gap between publication of the Commission's recommendations in early June and the European Council at the end of the month was too short for them to be thoroughly reviewed. The Hungarian Presidency has also publicly criticised the Commission for not allowing some 'give and take' with national officials before publishing its recommendations. The Commission insists its independence and credibility would be undermined if it engaged in a dialogue with national authorities over the content of the recommendations – an argument which signals a lack of self-confidence, which is a prerequisite if the European semester is to provide added value. The Commission must be confident and strong enough to cope with, and respond to, criticism from national capitals. It must engage in a debate with national authorities if it wants to be taken seriously. If it lacks the ability and resolve to do so, it might be worth considering establishing an independent group consisting of 'wise women and men' tasked with providing the Commission with an independent assessment of the economic situation in Member States.

- *Lack of ambition:* The Member States' economic programmes do, by and large, follow the priorities outlined in the Commission's Annual Growth Survey. However, in most cases they lack ambition, as many of the proposed measures are not very innovative and remain rather vague and unspecific. The definition of common rules, which Member States need to follow when drafting their programmes, could provide some orientation and pressure national authorities to make them more concrete. With respect to the Euro Plus Pact, the Summit Conclusions at least point in the right direction, as the participating Member States have pledged to: (1) make their future commitments more "specific and measurable", giving details of how and when commitments will be met; (2) focus more on "frontloading growth-enhancing reforms", and (3) strive towards a "higher degree of ambition".

- *Loose intergovernmental coordination:* The European semester and the Euro Plus Pact have been criticised for the fact that national policy-makers – even those tied together by the euro – have opted for loose coordination rather than genuine harmonisation and integration of national economic policies. The first experience with both instruments seems to justify this criticism. However, it is still too early to deliver a final verdict, and one should not disregard the potential of the European semester and the Euro Plus Pact by simply comparing them to previous, somewhat ineffective attempts at loose economic coordination between Member States (e.g. the Lisbon Strategy or Open Method of Coordination), for one main reason. The crisis has underlined how highly interdependent Member States are, particularly within the euro zone. The experience of the sovereign debt crisis has the potential to increase the 'level of ownership' with regard to instruments like the European semester or the Euro Plus Pact. However, this will require euro-zone countries – especially those called on to bail out stumbling partners – to be deeply committed to the new instruments, and to support and push the Commission to produce more revealing assessments and concrete recommendations. During his press conference, President Van Rompuy said all members of the European Council are "personally committed to implementing the Commission's recommendations". But is this really true? It seems revealing that Chancellor Merkel argued in her press conference that the Commission's recommendations are "contributions to the debate" and that it is not really "desirable and feasible" to implement them on a "one-on-one basis". If this approach prevails, it will vindicate critics who have argued that the new instruments are unlikely to make a difference.

Finally, some non-euro countries had expressed fears that the Euro Plus Pact would foster the creation of a two-speed Europe. Initial experience does not suggest these fears are justified. On the contrary, the fact that non-euro zone countries have joined the Pact has provided some of them the opportunity to show their eagerness and readiness to support a further deepening of economic coordination – indeed, some non-euro countries such as Poland have presented more concrete and ambitious commitments than countries already in the euro zone.

Extension of EFSF and agreement on the ESM treaty

EU leaders endorsed reforms of the European Financial Stability Facility (EFSF) and the agreement on the permanent European Stability Mechanism (ESM).

With respect to the EFSF, they welcomed an increase of its effective lending capacity, which under current conditions only amounts to approximately half of its nominal €440 billion capacity because of the guarantees necessary for a triple-A rating. This increase, which now needs to be ratified by all euro-zone countries, will be achieved by increasing the EFSF's guaranteed capital from €440 to €780 billion.

EU leaders also endorsed the agreement reached on the permanent ESM, which will replace both the EFSF and the European Financial Stabilisation Mechanism (EFSM) in 2013. The ESM treaty follows the general features already accepted by EU leaders at the March Summit. Hence, it will be 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 to provide, together with the IMF, assistance to euro countries in difficulty, on the basis of strict conditionality.

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 paid-in capital will be phased in from July 2013 in five equal annual instalments. In line with the current EFSF, the ESM will seek to supplement its lending capacity through the participation of the IMF and non-euro Member States.

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 unanimously on the basis of a public-debt sustainability analysis of the Member State concerned conducted by the Commission and the IMF, liaising with the ECB. In other words, every country will be able to block 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.

There is one notable change to the agreement reached in March: bonds issued by the ESM will not enjoy a preferred creditor status, which would have put them at the head of the queue for repayment. There had been worries that this would discourage investors from buying bonds from countries that might be forced to ask the ESM for assistance. The change brings the new Mechanism in line with the EFSF and is a concession to the three countries already subject to bail-out loans. Irish Finance Minister Michael Noonan described it as “very good news for Ireland”. The hope is that it will help distressed countries return to capital markets more quickly.

However, the move will further burden the ratification of the ESM treaty, especially in EU countries that would bear the biggest financial risks in the event of a debt restructuring. Some have argued that it increases the danger that countries like Austria, Finland, Germany or the Netherlands would lose even more money in the event of a sovereign default. Problems with ESM ratification are also likely to come from some national parliamentarians who will use the opportunity to publicly challenge the permanent rescue mechanism and ask for safeguards guaranteeing the involvement of parliaments if ESM loans are ever required.

National legislators in the strongest economies can, however, herald the fact that the revised ESM treaty sticks to the provision 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 realistically do this by itself. 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 maturity, interest cuts and/or haircuts) if the debtor is unable to honour obligations. Compared to the current situation, CACs could in future cases facilitate negotiations with creditors. However, the Greek example shows that broader systemic considerations can strongly determine the terms of negotiations and the extent of a restructuring.

Finally, there have been no changes with respect to a potential additional use of the ESM beyond providing loans to struggling governments. It is not foreseen that the Mechanism will be used to (1) purchase bonds of distressed countries directly; (2) allow governments to use loans to buy back their own debt on the secondary market; (3) use funds for short-term credit lines to governments struggling to borrow money but not in need of multiannual bail-out packages; or (4) use the ESM to provide financial support to help stabilise European banks, which are still at the heart of the crisis.

Six pack – no cheers, yet

EU leaders had hoped to be able to welcome and celebrate the adoption of the package of six legislative proposals aimed at enhancing economic governance. Although the European Parliament and Council were close to a compromise, the negotiations could not be concluded ahead of the Summit and thus the European Council could only welcome the "substantial progress" made. However, an agreement on the six pack ahead of the summer break still seems feasible, as MEPs and Member States have reached an agreement on almost all contentious issues.

The six pack includes five regulations and one directive proposed by the Commission in September 2010 in line with the recommendations made by the Task Force on economic governance chaired by President Van Rompuy and endorsed by the European Council in October 2010. They include setting up a new annual assessment of the risks of macro-economic imbalances and vulnerabilities, and reforming and strengthening the Stability and Growth Pact (SGP).

MEPs had submitted more than 2,000 amendments before trialogue negotiations between the Council, Parliament and Commission began in April. The compromises reached ahead of the Summit reflect some of the Parliament's key requests, including: (1) an enhanced role for MEPs in the European semester and a codification of this into the legal text, thereby giving legal weight to this new procedure; (2) the Parliament's involvement in the setting-up and functioning of the macro-economic scoreboard; (3) an enhancement of the independence of statistical authorities and the introduction of a fine (0.2% of GDP) for Member States falsifying fiscal statistics on deficits and debt; (4) an expansion of the application of reverse qualified majority voting to make warnings and sanctions more automatic, particularly in cases where a Member State has not taken corrective action to reduce identified macroeconomic imbalances; (5) a strengthening of the Commission's powers through provisions obliging Member States to supply more information; (6) more details on the indicators to be used for assessing macroeconomic imbalances, including those related to the social dimension; and finally, (7), a Commission commitment to study the feasibility of Eurobonds.

The major remaining bone of contention between the Parliament and Member States relates to a further expansion of the reversed majority rule when it comes to imposing sanctions on countries which disregard the Commission's warnings on expenditure overshoots. The Parliament is trying to overthrow the Franco-German deal reached in Deauville last October, when Chancellor Merkel accepted French demands to give governments more control over the imposition of sanctions in the framework of the renewed SGP. A majority of Member States, led by Paris, argue that disciplinary procedures must require national governments' overwhelming support, giving them a break on the system.

MEPs are seeking concessions from Member States in two other areas. First, they want finance ministers to appear before the Parliament when their countries have failed to implement certain commitments and decisions agreed on the European level. Second, they want a more balanced macroeconomic surveillance system which looks not only at countries facing a loss of competitiveness but also at Member States with a high-surplus current account *vis-à-vis* other countries – a symmetrical approach which is strongly opposed by Berlin.

The final phase of the trialogue will be difficult, but an eventual compromise is likely as both Council and Parliament are aware that a further postponement or failure of the negotiations would send a message to the markets that the EU is incapable of enhancing economic governance. At his press conference, President Van Rompuy reminded the Parliament that "the better should not be the enemy of the good". The pressure to find a compromise on the outstanding issues is particularly high for the governments of Austria, Finland, Germany and the Netherlands, which require a toughening of the rules to win popular and parliamentary support for further rescue efforts and for ratification of the ESM treaty.

Migration and the free movement of people

On the second day of the Summit, EU leaders set orientations for the governance of the Schengen area, the control of external borders, the development of partnerships with neighbouring countries, and the completion of the Common European Asylum System.

The arrival of more than 25,000 migrants from north Africa, the proposal from President Sarkozy and Italian Prime Minister Silvio Berlusconi to amend and further clarify the existing Schengen rules, and the Danish plan to re-introduce customs controls, had all combined to reignite the sensitive debate about migration and the free movement of people in the run-up to the Summit.

Schengen reform

The reform of the Schengen regime was the most contentious issue on the agenda on day two of the European Council. Aiming to calm the atmosphere, the Summit Conclusions praised the free movement of people as one of the most tangible and successful achievements of European integration, but acknowledged the need to enhance mutual trust between Member States and to improve the existing Schengen regime.

At first sight, it might seem as if EU leaders backed the Franco-Italian initiative by agreeing in principle to allow for temporary reintroductions of border controls. However, a closer analysis reveals that the mechanism will be very complex and difficult to apply. The original idea proposed by Sarkozy and Berlusconi has in fact been substantially watered down following strong opposition from a vast majority of Member States.

The wording of the Conclusions and the strict conditions and complex procedures attached to a reintroduction of border controls will make it difficult for Member States to use the new mechanism in practice. EU leaders agreed that a country "facing heavy pressures at the external borders" should be able to trigger a "safeguard clause" to allow the "exceptional reintroduction" of internal border controls but only in a "truly critical situation where a Member State is no longer able to comply with its obligations under the Schengen rules". Such a measure should only be taken "as a very last resort", on the basis of "specified objective criteria" and a "common assessment" for a "strictly limited scope and period of time."

The European Council invited the Commission to submit a proposal for such a mechanism in September 2011. The Commission will now have to come up with concrete proposals specifying and clarifying the many criteria listed in the Summit Conclusions. President Barroso himself had already indicated before the Summit that he (and his institution) would support the reintroduction of temporary border controls, but only if such decisions are taken via an EU-based mechanism and not unilaterally.

The Commission would now be well advised to take a two-pronged approach: on the one hand, it should strictly guard the Treaties and defend the Schengen regime and the principle of free movement against any breaches by individual Member States; on the other, it should be constructive and take the arguments put by those EU countries asking for a reform of the Schengen rules seriously. Failure to do this could provide governments and opposition leaders with an ideal opportunity to launch populist attacks on the EU (once again).

External border controls

The references in the Summit Conclusions to external border controls are more general and less contentious than those on Schengen. EU leaders called for an effective and consistent management of Europe's external borders and reiterated that it is the Member States that are ultimately responsible for the control and surveillance of the EU's external borders. In more concrete terms, heads of state and government:

- called for a further development of the European Border Surveillance System (EUROSUR) as a matter of priority, so that it can be operational in 2013. EUROSUR aims to support Member States in their effort to reduce the number of illegal immigrants entering the Union;
- welcomed the agreement reached between the Council and Parliament on the revision of the Frontex Regulation, which strengthens the agency's operational capacities and its mandate by allowing Frontex to operate also outside the EU. The Conclusions stress that the functioning of Frontex and other agencies needs to be continuously monitored to ensure their efficiency in assisting Member States in managing border controls;
- underlined the need to progress rapidly on "smart borders" to ensure that new technologies are harnessed to meet the challenges of border control;
- stated that the framework for cooperation between national border guards will be further developed, notably by promoting common training and the sharing of capacities and standards.

Following the events of recent months, it is noteworthy that the European Council reaffirmed the need for "genuine and practical solidarity" towards EU countries most affected by migratory flows. However, it remains to be seen what this will mean in practice if pressures on the borders of Italy and/or Greece, in particular, increase in the months and years to come. The Commission has been asked to come forward with a communication on intra-EU solidarity later this year.

Cooperation with third countries

With respect to cooperation between the Union and the countries in its neighbourhood, EU leaders underlined the need for a consistent and strategic policy to "manage mobility in a secure environment", and reiterated the importance of developing partnerships with the countries of the southern and eastern neighbourhood. The latter is particularly significant as Poland and other eastern European countries have been especially eager to maintain a strong focus on the 'Eastern dimension'.

The Conclusions state that the objective is to address the root causes of migration at a structural level. At his post-Summit press conference, President Van Rompuy went a step further, stating that the best way to reduce migratory pressure on the Union's southern borders is by "helping young people in northern Africa and the Middle East to build a future in their own country. Successful migration policy starts outside the EU borders."

Nobody would object to this assessment. However, a careful reading of the Summit Conclusions testifies that the EU is continuing to concentrate on security-oriented issues (with a special emphasis on border controls) and highlight the importance of conditionality in the relationship with the southern neighbourhood. The Conclusions state that bilateral mobility partnerships should be differentiated according to the individual merits of partner countries, and conditional on efforts and progress made in all areas of cooperation. This approach, which seems to adhere to a rather strict interpretation of the conditionality principle, is not new and has in the past been rather ineffective.

The EU should revise its approach to the external dimension of migration. Currently, the possibility for non-EU countries to engage in legal migration negotiations with the EU and its members is conditioned by their involvement in the management of borders and the fight against irregular migration. From a short-term and purely European perspective, this approach seems to make sense, but from the perspective of partners and citizens in Europe's southern neighbourhood, it conveys the picture of a defensive, stability-oriented 'fortress Europe' – an image which will hamper the EU's efforts to play a key role in the historical developments taking place in northern Africa and the Middle East.

Taking into account demographic trends and recent political developments in the EU's southern neighbourhood, the Union should re-consider and adapt the conditionality approach by developing a new and open partnership based on a facilitated movement of people from third countries to the EU. Increased legal migration access, visa liberalisation programmes and the recognition of diplomas, as well as comprehensive development policies (including trade, remittances or education), should be seriously explored and implemented for the benefit of the EU and countries of origin.

Without a more constructive, reciprocal and open approach, the EU will not be able to fulfil the high aspirations and role that President Van Rompuy ascribed to it in his press conference when he said: "Without Europe there would have been an Arab Spring, but without us there will be no Arab Summer."

Asylum

The European Council also addressed issues related to asylum. However, the relevant paragraph in the Summit Conclusions is limited to already defined objectives and ongoing developments. In more concrete terms, the European Council recalled the need to complete the Common European Asylum System (CEAS) – which aims to create a level playing field where any person seeking protection will be treated in the same way, according to the same standards, wherever they apply for asylum – by 2012. It is, however, doubtful whether the deadline is realistic, as a number of key texts are still under negotiation.

Croatia, Draghi and the Arab Spring

The June Summit was mostly devoted to issues related to the economy and migration. However, EU leaders also addressed a number of other subjects, including Croatia's EU accession, Mario Draghi's appointment as ECB President, and recent developments in northern Africa and the Middle East.

In the light of progress made and taking into account the Commission's positive assessment, EU leaders invited the Council to conclude the accession negotiations with **Croatia,** which began in 2005, by the end of June. This is a major success for the Hungarian Presidency and it is now up to the Polish Presidency to push forward and finalise work on the Accession Treaty to be signed before the end of 2011. EU leaders have, however, declared that the Union will monitor Croatia's reform efforts, in particular as regards the judiciary and fundamental rights, up to the moment of accession.

The European Council appointed Bank of Italy Governor **Mario Draghi** as the next President of the ECB. The economist and former banker will succeed Jean-Claude Trichet on 1 November 2011; his mandate will end on 31 October 2019. The decision was taken after another Italian, Lorenzo Bini Smaghi, agreed to step down from the ECB's Executive Board by the end of this year. This concession came after President Sarkozy insisted that France would not accept two Italians at the top of the ECB.

The European Council adopted a declaration on the **southern neighbourhood** in which EU leaders endorsed the Council conclusions on the new European Neighbourhood Policy (ENP) and welcomed the steps towards democratic transformation in Egypt and Tunisia, the new Constitution in Morocco, the renewed commitment to political reforms in Jordan, and the lifting of the state emergency and planned constitutional reform in Algeria. EU leaders also reiterated their call to Gaddafi to relinquish power, and acknowledged the essential role played by the Transnational National Council (TNC) in Libya's democratic transformation process as a representative of the aspirations of the Libyan people. They condemned in the strongest possible terms the Syrian regime's ongoing repression and unacceptable violence against its own people, warned that those responsible for crimes and violence against civilians shall be held accountable, and expressed concern about the situation in Yemen and urged all parties to stop violence. EU leaders also underlined the need for progress in the Middle East Peace Process and called on all parties to urgently engage in negotiations.

Finally, the European Council EU endorsed the EU **Strategy for the Danube Region** and the report of the Hungarian Presidency on **Roman inclusion**, and welcomed the annual report on **EU development aid targets**, noting, however, that while the EU is the largest donor in the world, it has missed the collective target for 2010.

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