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Post-Summit Analysis

Adding pieces to the European economic governance puzzle

Summary

The European Council meeting on 16-17 December was once again dominated by the euro crisis, with EU leaders adding new pieces to the enhanced European economic governance puzzle. In this EPC analysis, Janis A. Emmanouilidis argues that EU leaders were justified in heralding the decision to establish a European Stability Mechanism as a major success. But he warns that there are still a number of key issues which need to be elaborated and clarified, and that the basic question remains: will the new mechanism and all the other reforms agreed this year be sufficient to rescue the euro and the EU itself?

Full report

The European Council meeting on 16-17 December was once again dominated by the euro crisis, with EU leaders adding new pieces to the enhanced European economic governance puzzle.

Earlier Summits had taken decisions related to the reform of financial supervision, the introduction of a 'European semester', the creation of a stricter 'Stability and Growth Pact III', and the establishment of a macroeconomic surveillance system. At the December European Council, EU leaders agreed on the general features of a "European Stability Mechanism" (ESM) and outlined details of a limited change to the Lisbon Treaty. However, some of the pieces still have blurred edges, others are still missing and it is by no means clear whether together they will eventually provide a recipe for success.

The EU Summit took place in a heated financial and political atmosphere. The European Council's last meeting in October had failed to calm the markets - quite the opposite. As predicted at the time by European Central Bank President Jean-Claude Trichet, the decision to introduce an insolvency procedure involving private investors triggered major turbulence on the financial markets.

Government representatives and EU institutions were once again forced to act to contain the turmoil. The finance ministers of the five biggest euro-zone countries - France, Germany, Italy, Spain, and the UK - even had to issue a joint statement from the G20 Summit in Seoul assuring investors that the new rules would only apply to bonds issued after 2013. The statement was a reaction to a sharp sell-off of Irish, Portuguese and Greek government debt in particular, because of fears that bondholders would have to take a loss in the case of default. The leaders of the weakest euro-zone countries also tried to calm the markets, but forecasts still suggest that there is more than a 50% chance of a Greek default and a 30% chance of Ireland and Portugal defaulting.

As big investment funds stopped buying the debt of 'peripheral' countries, the ECB was obliged to step up its purchases of euro-zone state bonds substantially to prevent the crisis spinning out of control. But in spite of these efforts and notwithstanding earlier denials, Ireland was forced to seek shelter under the European rescue umbrella and fears have since increased that the crisis could spread to Portugal, Spain or even Italy and Belgium. However, compared to earlier this year when the value of the euro declined sharply during the Greek crisis, this time around it remained relatively stable.

The weeks and days ahead of the December Summit were marred not only by financial turmoil but also by political disunity, a cacophony of voices and mutual finger-pointing, with Berlin increasingly pushed into a corner. There were increasing tensions between euro-zone leaders over how to deal with the sovereign debt crisis, with Greek Prime Minister George Papandreou, for example, publicly declaring that the German government's insistence on introducing an insolvency procedure would force the weakest euro-zone countries into insolvency. German Finance Minister Wolfgang Schäuble responded by reminding Greece that EU solidarity is not a one-way street and Chancellor Merkel declared at a party conference that the decision in 2000 to admit Greece into the euro zone had been a mistake.

But the most severe round of squabbling broke out in the week before the Summit after Luxembourg Prime Minister Jean-Claude Juncker and Italian Finance Minister Giulio Tremonti published a joint article in the *Financial Times* on December 6 calling for the introduction of European bonds issued by a "European Debt Agency" as a successor to the current European Financial Stability Facility (EFSF).

They argued that the EU must formulate a "strong and systemic" response to the crisis, to send a clear message to global markets and European citizens of the Union's "political commitment to economic and monetary union, and the irreversibility of the euro". "E-bonds" would, according to Juncker and Tremonti, impose market discipline on governments without exposing them to "speculative attacks" and create an attractive bond market for international investors.

The idea was warmly welcomed in a number of Member States, by some institutional actors and MEPs, and even by the main opposition parties in Germany, but was immediately dismissed by Chancellor Merkel and subsequently also by the leaders of Austria, Finland, France, Slovakia, Sweden and the Netherlands.

Merkel argued that such bonds would "not create the right incentives" and would not be "compatible with existing treaties". Their introduction would, according to German officials, remove a vital element compelling euro-zone members to control their debt and deficit spending. Some German media claimed that common European bonds would increase Germany's borrowing costs by €17 billion. There are also fears that the introduction of e-bonds could give Berlin domestic headaches, given that Germany's Constitutional Court is already mulling the legality of the current bail-out mechanism.

In reaction to this rebuff, Juncker accused the German government of rejecting his e-bond idea before it had been studied properly. He added that "this way of creating taboo areas in Europe and not dealing with others' ideas is a very un-European way of dealing with European matters". He argued that only part of European debt (40%) should be covered by e-bonds and thus would not lead to one common interest rate, as highly indebted euro-zone countries would have to pay a much higher rate for their national bonds. This suggests that the additional borrowing cost estimates in the German media were inaccurate, and claims that European bonds would not be compatible with the current Treaties are also questionable given that the EFSF already issues bonds guaranteed by all euro-zone countries.

The debate surrounding European bonds was the clearest demonstration of worsening tempers within the EU. But at the Summit itself, EU leaders tried their best to hide their differences and put on a show of unity to the markets and European citizens. The e-bond idea was not on the official agenda, although it was brought up and dismissed once again during the working dinner.

EU leaders repeatedly confirmed that they are ready to do whatever is necessary to ensure the stability of the euro zone, and euro-zone leaders and the EU institutions decided to issue a separate statement attached to the European Council Conclusions in which they declare that they "stand ready to do whatever is required to ensure the stability of the euro as a whole".

In more concrete terms, EU leaders agreed on the details of a limited treaty change and on the key features of a permanent European Stability Mechanism.

Limited treaty change - details and dangers

In line with the principles endorsed at the October Summit, EU leaders agreed on the details of a limited treaty change. The amendment will add a paragraph to Article 136 of the Treaty on the Functioning of the European Union (TFEU), which is in Part Three of this Treaty and concerns closer cooperation among euro-zone countries.

The agreed amendment will not affect Article 122 TFEU, as initially rumoured in late October. In effect, the European Council Conclusions explicitly state that Article 122.2 TFEU will no longer be applied in the context of safeguarding the financial stability of the euro area. The German request to temporarily suspend voting rights in cases of 'fiscal misbehaviour', which had been tabled at the last Summit, has been dropped.

The Treaty will be amended using the *simplified revision procedure* introduced by the Lisbon Treaty (Article 48.6 Treaty on European Union (TEU)), which allows the European Council to adopt a unanimous decision amending all or part of the provisions of Part Three of the TFEU, as long as an amendment does not increase the Union's competences.

This will enable the European Council to act fairly autonomously, although it will have to consult the European Parliament and the Commission, as well as the ECB as the amendment affects the monetary area. The major advantage of this procedure is that it is simple and less time-consuming than the ordinary revision procedure, as it requires neither an Intergovernmental Conference nor a Convention. The latter would not only be time-consuming, but the involvement of a plethora of national and European players could also open up the spectre of a more comprehensive and thus complicated treaty reform.

The European Council agreed on the text of the draft decision amending Article 136 and decided to launch the simplified revision procedure immediately. The consultation of the institutions concerned should be concluded in time to allow for formal adoption of the decision in March 2011. National approval procedures (i.e. ratification) should be concluded by the end of 2012, so that the amendment, which is a prerequisite for setting up the European Stability Mechanism, can enter into force on 1 January 2013.

The exact wording of the new paragraph added to Article 136 is as follows: "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 area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality."

Compared to earlier versions, the first of the two additional sentences added to this paragraph now clearly states that the permanent stability mechanism would only "be activated if indispensable" - a concession to the German government, which is keen to send a clear message to the Karlsruhe court that the mechanism will only be employed as an *ultima ratio* in the event that the euro's stability is endangered.

The biggest challenge to the agreed treaty change stems from the fact that it will have to be ratified in all EU countries before it can enter into force. Obviously, this challenge will be greatest if it becomes subject to a referendum in one or more Member States - hence the emphasis put on the fact that the reform of Article 136 TFEU does not foresee any transfer of competences from the national to the Union level. European Council President Herman Van Rompuy stated at a Summit press conference that "to our knowledge no referendum is needed". But in spite of all such reassurances, the possibility of a referendum in one or more Member States cannot be excluded.

The 'danger' is probably highest in Ireland, even though the current government is eager to avoid another popular vote after its traumatic experience with the Lisbon Treaty. According to the Irish Supreme Court, the legal trigger for a referendum relates to whether a treaty reform alters the "essential scope and objectives" of the Union. Now, from a legal perspective one could argue that the proposed amendment will not transfer additional competences from the national to the Union level, especially as the permanent stability mechanism will be based on an intergovernmental construction, but past decisions in Ireland to hold a referendum have not been taken solely on legal grounds.

There are two potential lines of political reasoning which could be used to argue for a referendum. First, Irish governments have in the past 'voluntarily' opted to hold a popular vote to avoid the risk of being 'asked' to do so by the courts; and second, some might argue that national sovereignty is (strongly) affected, especially if a country has to seek shelter under the European rescue umbrella. National decision-makers then have not only to accept the strict conditionality attached to the mechanism, but their room of manoeuvre is also limited by the fact that national reform and austerity programmes are subject to tight surveillance by the Commission, the International Monetary Fund (IMF) and the ECB. Popular support for such arguments is likely to increase if the economic, political and social situation in Ireland deteriorates.

But the 'ratification danger' is not limited to Ireland. Some governments might link the ratification of the treaty amendment to other issues, as has happened in recent weeks and months. The UK government has, for example, behind the scenes linked its readiness not to hold a popular vote to the budget debate. More recently, the Greek prime minister created a political *junctim* between the prolongation of Greek loans and the ratification of a limited treaty amendment. Other similar *junctims* could follow and thus endanger the entry into force of the new treaty provision by 2013, when the *ad hoc* rescue mechanism will expire, which could severely destabilise the financial markets. It seems thus advisable to think of a 'Plan B' early on.

Main features of the European Stability Mechanism

The European Council agreed to establish a permanent European Stability Mechanism to safeguard the financial stability of the euro area to replace both the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM), which will remain in force until June 2013.

The EFSF and EFSM are – together with the IMF's financial contribution (€250 billion) – the two main financial pillars of the €750-billion rescue umbrella for euro-zone countries. The EFSF is an *ad hoc* emergency measure established by an Ecofin decision on 9 May 2010 to safeguard financial stability in Europe. The EFSF is a Luxembourg-registered company owned by euro-area members and set up outside EU institutions, which can issue triple-A bonds guaranteed by its owners for up to €440 billion for on-lending to euro-zone countries in difficulty. The EFSM is a facility administered by the Commission able to provide up to €60 billion in loans to Member States.

The present *ad hoc* construction needs to be replaced, because it was deliberately given a limited three-year lifespan and because the German government has declared that it will not agree to prolong its existence in its current form after 2013 for two main reasons. First, Berlin fears that the current arrangement could be successfully challenged in Germany's Constitutional Court. Second, the current arrangement puts the main burden on euro-zone countries and their taxpayers and not on private lenders, and Germany, supported especially by Austria, France and the Netherlands, is insisting that private investors should be obliged to carry a share of losses if a euro-zone country's debt needs to be restructured.

The European Council endorsed an agreement on the ESM reached by EU finance ministers on 28 November. The new permanent mechanism will have the following key features:

- The ESM will be activated in case of risk to the stability of the euro area as a whole. Euro-zone countries can thus only receive assistance in the event of a major systemic danger to the common currency.

- The ESM will be able to provide financial assistance to euro-area members under strict conditionality, in line with the rules of the current EFSF.

- Assistance will be based on a stringent programme of economic and financial adjustment and a rigorous debt sustainability analysis conducted by the Commission and the IMF, in liaison with the ECB.

- Assistance will require a unanimous decision by Eurogroup ministers.

- To protect taxpayers' money and to send a clear signal to private creditors that their claims are subordinated to those of the official sector, an ESM loan will enjoy preferred creditor status, junior only to the IMF loan.

- For countries considered solvent, private-sector creditors will be encouraged to maintain their exposure.

- Insolvent countries will have to negotiate a comprehensive restructuring plan with their private-sector creditors, in line with IMF practices, with a view to restoring debt sustainability. If sustainability can be achieved through these measures, the ESM may provide liquidity assistance.

- 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 June 2013. CACs will include aggregation clauses enabling creditors to agree by qualified majority on a legally-binding change to the terms of payment (standstill, extension of the maturity, interest rate cuts and/or haircut) in the event that the debtor is unable to honour obligations.

- The ESM's rules will be adapted to provide for a case-by-case participation of private-sector creditors fully consistent with IMF policies.

The ESM's principle features are in line with the arrangements in the current *ad hoc* mechanism. In short: the ESM is a last-resort mechanism able to provide assistance to euro-zone countries on the basis of strict conditionality.

The major innovation relates to the involvement of private investors in the event of a debt restructuring. However, following the turmoil caused by the October decision to involve private lenders, EU governments have been anxious to calm the markets. This is why they emphasised that any restructuring plan will be in line with IMF practices, that CACs will be consistent with those common under UK and US law, and that any private-sector involvement will not be effective before mid-2013. The latter means that private investors could be asked to 'pay' their share of a state insolvency much later, probably close to the end of the decade when bonds including CACs will reach maturity, and not during the current crisis.

The most significant signal sent to the markets is that the decision to involve private-sector investors will be taken on a case-by-case basis and not following a more automatic procedure, as originally foreseen by Berlin. French officials have been particularly eager to downplay the significance of the new provision, 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 would be different and the conditions attached to a potential restructuring would thus have to reflect the debt situation of the country concerned. Second, if financial support automatically led to debt restructuring, the markets would be tempted to attack the weakest euro-zone members even if these countries were not yet insolvent.

Concerning timing and procedure, EU leaders have agreed that euro-area finance ministers and the Commission shall finalise work on the intergovernmental arrangement setting up the future mechanism by March 2011. Non-euro countries can, if they wish, be involved in this work and may decide to participate voluntarily in operations launched under the mechanism on an *ad hoc* basis. The overall effectiveness of the new framework will be evaluated in 2016 by the Commission in liaison with the ECB.

Again, more questions than answers

EU leaders were justified in heralding the decision to establish a European Stability Mechanism as a major success. It adds an important and indispensable element to the enhancement of European economic governance, and who would have thought earlier this year, when Member States were struggling to find a common response to the Greek crisis, that EU governments would agree to the principle features of a permanent crisis facility by the end of 2010?

However, there are still a number of key issues which need to be elaborated and clarified. And the basic question remains: will the ESM and all the other reforms be sufficient to rescue the euro and the EU itself?

But let us first have a look at some of the unsettled issues and ambiguities related to the European Stability Mechanism.

The size of the mechanism

What funds will be made available to the new permanent crisis mechanism? Reflecting growing concerns that the current lending capacity might not be sufficient, the Belgian Presidency, the IMF and the ECB called before the Summit for an increase in the funds available to assist euro-zone members through the EFSF, arguing that this would send a strong signal to the markets and investors and help stop the exit of capital from weaker euro-zone countries' bond markets. But Germany, Finland, France, the Netherlands, and Slovakia argue that an increase is not necessary, at least not for the time being, as only €17.7 billion of the €440 billion available has been used for the €85-billion Irish bail-out package.

In the statement added to the Summit Conclusions, euro-area leaders committed themselves to ensure the "availability of adequate financial support" through the existing EFSF. But this issue will resurface again in early 2011. One option already being discussed is to explore ways to enable the EFSF to lend more money to struggling governments without actually increasing the size of the fund. Currently, the facility must hold back about one-third of the €440 billion it can borrow to provide the cash buffer required to guarantee its triple-A status. Others have argued that the EFSF's lending capacity should be doubled or even tripled. In any case, the overall size of the ESM will largely depend on the new mechanism's future tasks (see next point).

Extended use of the ESM

Could the EFSF's tasks, currently 'limited' to providing loans to struggling governments on the basis of strict conditionality, be extended? In the discussions on the details of the permanent mechanism, the possibility of using the available funds in at least three additional ways could be considered:

(i) The ESM/EFSF could be used to purchase distressed governments' bonds to stabilise the markets. Until now, this has 'only' been done by the ECB, which has acted as a defender of last resort buying up bonds of weak euro-zone countries to stop contagion. The ECB Governing Board's decision, only days before the Summit, to double the Bank's subscribed capital from €5.8 billion to €10.8 billion until 2012 shows that central bankers are ready to extend the existing securities market programme. However, the ECB runs the risk of losing its independence and credibility or even becoming a 'bad bank' because of the toxic assets it holds.

(ii) ESM funds could be used for short-term lines of credit to euro-zone governments struggling to borrow money but not in need of multi-year bail-out packages.

(iii) The ESM/EFSF could, as the IMF and others have proposed, provide financial support to help stabilise European banks, which are still at the heart of the current crisis. The Irish crisis has proved that the bank stress tests published in July did not provide an accurate picture of the situation in the banking sector. They concluded that the Bank of Ireland and the Allied Irish Banks were strong enough to face the crisis, but their fragile situation became obvious only weeks later when big investors abandoned these and other Irish banks. One could argue that the main problem in the current euro crisis is not so much indebted euro-zone countries but rather the hidden toxic assets of European banks, which can blow the system to pieces, and that it makes sense to support the banking sector through the ESM/EFSF to avert this danger. Some, like Wolfgang Münchau of the *Financial Times*, even argue that the EFSF should be charged with the "restructuring and downsizing of the European banking sector".

Fixing the interest rate

What interest rates will a country have to pay for loans provided through the permanent crisis mechanism, and what criteria will be used to determine these rates? Some have argued that the current rates being paid by Greece and Ireland (close to 6%) are too high. Others argue that this is still cheaper than the market rate and that some 'penalty' is necessary to avoid 'moral hazard' and to ensure that the countries concerned remain committed to reform.

Limits of conditionality

What conditions will be attached to use of the ESM, and what economic, social and political 'penalties' must a country be ready to pay for using the permanent crisis facility? It goes without saying that euro-zone countries which receive massive loans from the rescue mechanism will have to reduce their debt and deficit levels and implement rigorous reform programmes. However, the first 'test case' - Greece - has shown how difficult it is to make unprecedented cuts in public spending and undertake massive and long-overdue reforms in a relatively short period of time.

Cutting public expenditure, reducing an oversized public sector, fighting corruption and tax evasion, or introducing profound reforms of the social and educational sector, are in the country's self-interest. But Greece is suffering from a 'slow death' of its economy, with enormous economic, social and political consequences. Up until now, the government has been (more or less) able to stick to its promises and obligations, but increasing despair, social unrest and political anger could endanger the pace of reforms.

These problems are not limited to Greece. The IMF has already warned of the "enormous political risks" in Ireland, and other weak euro-zone countries are confronted with similar challenges. These problems also have detrimental effects on stronger EU countries and on the overall stability of the common currency. It thus makes sense to think of ways how to support and trigger economic growth, especially in Europe's periphery, through, for example, cross-border infrastructure investments co-financed through EU-project bonds as proposed by the Commission; the temporary suspension of the Structural Funds' co-financing requirement; the completion of the Single Market, especially in the services sector or the liberalisation and full integration of energy markets; or by strengthening internal demand in stronger euro-zone countries to counter increasing intra-EU imbalances.

Likelihood of a sovereign insolvency

A key question surrounding the permanent ESM relates to the possibility of a state insolvency in the euro zone. It is clear that the dogma that no euro-zone country could ever default has vanished. But will the insolvency procedure as foreseen in the ESM ever be applied in practice? There are two opposing lines of thinking.

An increasing number of experts argue that some sort of debt restructuring of the weakest euro-zone countries will be inevitable. Some even argue that the envisaged construction of the ESM will make a debt default even more likely, as the lending costs for weak peripheral countries are bound to increase substantially, thus pushing these countries even closer to a sovereign default.

Those who maintain that a debt restructuring is unavoidable argue that governments should start negotiating with their major bondholders (i.e. banks and other major investors) on the conditions of an orderly debt restructuring - ranging from a standstill, an extension of the maturity or an interest rate cut to the possibility of a 'haircut' - sooner rather than later, and consider ways to avoid the risk of contagion.

In a recent paper, for example, Daniel Gros argued in favour of a "big-bang" approach in which all the countries in question should in parallel "make investors an exchange offer while continuing to service their payment obligations". He argues this should not be a "technical default", but "simply an offer to bondholders to engage in discussions about debt restructuring accompanied by a concrete exchange offer". To avoid major turmoil in the markets, the ECB should stabilise the fragile banking system and the EFSF/ESM should take care of governments' financial needs. The absence of CACs in 'old' bonds does not, according to Gros and others, constitute an insurmountable obstacle to reaching an agreement with creditors. To calm the markets even further and make the offer to exchange old for new bonds more attractive, one could add to the proposal the idea that solvent euro-zone countries could guarantee that the new bonds are safe.

There are others who do not believe that debt restructuring is the way out of the crisis. They argue that it is highly unlikely that a euro-zone government will ever be pushed into sovereign default, because a restructuring of public debt including private investors 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 and have a destabilising effect: one sovereign default could trigger a chain of restructuring including other weak euro-zone countries; big banks and other major investors could suffer huge loses; and people might panic and spark a run on the banks. All this could in the end threaten the banking system, with major economic, social and political consequences not only for Europe but for the entire world.

But if a debt restructuring is not feasible, how will countries like Greece, Belgium, Portugal, Ireland or Italy cope with their high debt levels and increasing borrowing costs in the face of increasing interest rates, low growth, low competitiveness, and 'insufficient' inflation? Three options - none of them really attractive - seem possible.

One is that the weakest countries decide to leave the euro zone. However, this would not solve but rather aggravate the problems of the countries concerned. Leaving the euro zone would also have high economic, financial, social and strategic costs not only for the country concerned, but also for the entire euro zone and the EU itself.

A second option could involve debt restructuring without the involvement of private investors. This alternative starts from the assumption that large parts of the current public debt of the most indebted euro-zone countries will eventually be held by the ESM/EFSF, the IMF, and the ECB. A restructuring involving only these lenders - and not private investors, as existing bonds do not include any CACs - could avoid all the uncontrollable negative side-effects mentioned above. But this option would effectively mean that the taxpayers of the stronger euro-zone countries would have to 'release' the most indebted countries from great parts of their debt. It therefore seems rather unlikely or politically impossible, as politicians will not be able or willing to 'sell' it to their voters.

A third, and more likely, option foresees the weakest countries paying back their debt but receiving (additional) assistance from other euro countries for a longer period of time, and maybe even under more favourable conditions (i.e. lower interest rates). In return, the countries receiving assistance would have to increase their efforts to achieve fiscal sustainability and increase their national competitiveness to eventually return to economic growth, which is the prerequisite for reducing public debt levels. This would be a long and painful process for both sides, but it might in the end prove to be the only viable option from the perspective of both the weakest and strongest euro-zone members.

Will the medicine cure the patient?

Besides the many questions and ambiguities related to the establishment of the ESM, there is the bigger question of whether implementation of the decisions taken at recent EU Summits will be sufficient to solve the euro crisis. An increasing number of policy-makers, analysts and commentators argue that the EU will only be able to overcome the current crisis if Member States agree to a further deepening of the 'European project'. In other words, monetary union and the EU itself will ultimately risk failure unless the European construction develops into some sort of economic or even political union.

Chancellor Merkel and President Sarkozy announced in the run-up to the December Summit that they will come up with additional proposals in 2011 to better harmonise Member States' economic policies – without giving any concrete details at this point. Both leaders underlined the need to think about ways and means to increase the coherence of economic policies in the euro zone. Others, such as Belgian Finance Minister Didier Reynders, even called for a new Convention to work on all aspects of a truly common economic policy.

But what could a *gouvernement économique* look like and are Member States ready to jump into the deep end?

An additional transfer of competences would limit national prerogatives in the last remaining bastions of state sovereignty. EU countries have, in the course of the last 50 years, agreed to pool a large portion of their national powers. Extending this in areas such as social policy including pensions, labour and wage policy, or even tax policy would not only reduce their remaining powers, but also deprive national elites of their residual privileges. This is a major reason why national actors - governments, parliaments, parties and even constitutional courts - have up until now resisted a further expansion of EU competences, to avoid their own 'political castration'.

One must doubt that national policy-makers will be ready to further pool national sovereignty and harmonise their economic policies. It seems more likely that the proposals will call for, and maybe even lead to, stronger coordination but not to a real harmonisation and integration of national economic policies. 'Muddling through' has been the EU's dominant mantra in the past and this is not likely to change in the near future, especially given the level of increasing distrust between Member States in these times of multiple crises.

There are still grounds for hope that the EU will move closer to some sort of economic and maybe even political union over the next decade, but this will not happen because of a grand new vision or out of solidarity, but rather out of necessity - because if the EU cannot address and effectively respond to the fundamental challenges the European project currently faces, the whole process will be in question.

Strategic partnerships, Montenegro, Côte d'Ivoire, and Cancún

The December Summit was once again devoted almost entirely to issues related to economic governance reform. However, EU leaders also addressed a number of other issues, including the Union's relationship with key strategic partners, Montenegro's bid for EU membership, the situation in Côte d'Ivoire, and the outcome of the Cancún climate talks.

On the second day of the Summit, EU leaders discussed relations with **key strategic partners** in line with their agreement at the September Summit to intensify their involvement in EU external relations. President Van Rompuy briefed his colleagues on the outcome of the recent bilateral summits with US President Obama, Russian President Medvedev, and Indian Prime Minister Singh. During his press conference, Mr Van Rompuy argued that the new approach has allowed the Commission President and himself to convey a stronger EU message at bilateral summits with third countries.

The European Council also welcomed the first progress report presented by High Representative Catherine Ashton on the Union's relations with the US, China and Russia. The strategy paper calls on Member States to be more result-oriented by focusing on fewer priorities and producing more cohesive policies in the EU's relations with key strategic partners on the basis of "tailor-made strategies".

Concerning **EU-US relations**, the paper calls on the Union to intensify cooperation in areas such as energy and energy security, cyber-security, crisis management, and counter-terrorism. It also argues that the US still values the EU, but warns that Washington will turn away from the Union if it does not become more engaged and influential in Asia.

Concerning **EU-China relations**, the report proposes increased engagement with Beijing, including more technical, economic, financial and security co-operation. It urges a more coherent communication strategy *vis-à-vis* China, suggests trilateral EU-China-US meetings, and recommends dropping the arms embargo on China. It also suggests adopting a long-term strategy to persuade China to improve the rule of law and human rights.

Concerning **EU-Russia relations**, the report argues that there is no need to revise the Union's main objective, which is to promote modernisation and democratic transformation. The EU should promote Russia's "full integration into international rules-based political and economic structures".

The High Representative will present a review of the EU's partnership with India, Brazil and South Africa in early 2011.

EU leaders accepted the Commission's recommendation to grant **Montenegro** official 'candidate country' status. Montenegro, which only gained independence in 2006, is now - besides Croatia, the former Yugoslav Republic of Macedonia, Turkey, and Iceland - the fifth country with this status and the third in the Western Balkans. President Van Rompuy argued that this decision underlines the conviction within the European Council that the countries of the Western Balkans have a European vocation. However, it is not clear when the EU and Montenegro will open accession talks and how long these will last.

The European Council also issued a statement on the situation in **Côte d'Ivoire** urging the incumbent President Laurent Gbagbo, who has refused to accept the recent election result, to step down. This came a couple of days after EU foreign ministers had agreed to impose visa bans and asset freezes on Gbagbo and his most prominent followers. The European Council condemned the violence in the West African country since the second round of the presidential elections, called on all parties to act with restraint and recalled the availability of the International Criminal Court to prosecute those responsible for such acts. It called on all Ivorian leaders to place themselves under the authority of the democratically elected President Alassan Ouattara, and confirmed the Union's determination to take restrictive measures against those who continue to obstruct the respect of the sovereign will expressed by the Ivorian people.

Finally, the European Council welcomed the "successful outcome" of the COP-16 climate negotiations in **Cancún** as an important step forward in global efforts to reach the agreed objective of keeping below a 2°C increase in global temperatures, and noted the "successful implementation of the strategy it agreed in March". In Cancún, negotiators from 190 countries agreed on a text including pledges to reduce greenhouse gas emissions and establish a fund to help poor countries adapt to the consequences of climate change. However, much more work still needs to be done and big political challenges remain. The main objective now is to reach a final climate deal at the next UN climate conference in South Africa at the end of 2011. It is still unclear whether negotiations will lead to an extension of the Kyoto protocol or to a new agreement. Since Cancún, some policy-makers and commentators have called on the EU to deepen its commitment by increasing its emissions reduction target from 20 to 30%.

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