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Post-Summit Analysis

The prospects of ambitious muddling through – the results of an EU Summit in deep crisis mode

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Summary

To the relief of many and to the surprise of some, the 28-29 June EU Summit, which took place in 'deep-crisis mode' agreed, after lengthy discussions, on two immediate measures aiming to relax bond markets especially in Spain and Italy: direct bank recapitalisation and EFSF/ESM support without a full programme. In addition, EU leaders signed-off the 'Compact for Growth and Jobs' and took first steps and agreed on a process towards a 'Genuine Economic and Monetary Union'.

Following an analysis of the three major Summit decisions, this paper by Janis A. Emmanouilidis takes an upbeat approach arguing, however, that many questions, doubts and uncertainties remain. He concludes that the European Union (EU) will probably be in crisis mode for years to come, and that 'ambitious muddling through' will most likely remain the EU's dominant mantra on an inevitable, but uncertain and long journey towards a higher level of economic, fiscal and political integration.

Full report

The European Council meeting on 28-29 June 2012 took place in 'deep-crisis mode'. This was in contrast to the last ordinary Summit in early March 2012, when EU leaders had been eager to send a signal of hope to Europeans and to the rest of the world that the European Union was moving from 'crisis' to 'normal mode'.

Once again, the main issue was the euro-debt crisis. In the end, and after reshuffling the original agenda and following lengthy discussions on Day 1 of the Summit and strong pressures from Italy and Spain, euro-zone leaders reached agreement on two immediate crisis measures: direct bank recapitalisation and EFSF/ESM support without a full programme. The EU 27 also signed-off a 'Compact for Growth and Jobs' and agreed on next steps in the process towards a further deepening of economic and fiscal integration. However, many questions and uncertainties remain about these three key decisions.

In terms of the longer-term future, the June 2012 Summit has shown once again that 'ambitious muddling through' is the most likely scenario for the years to come, as the crisis will remain with us for some time (see pp.12). The process towards further economic, fiscal and political integration will be a long, bumpy and sometimes risky road with an uncertain final outcome. But before one embarks on that inevitable, but uncertain journey, EU institutions and Member States (actively supported by the ECB) will in the immediate future have to continue working hard to tighten a strong-enough safety net, capable of protecting the euro and the Union itself from hitting the ground when things get rough in the years to come.

Back to deep crisis mode

In the run-up to the June 2012 Summit, the crisis appeared to be moving steadily closer to 'crunch time' and there was no longer any doubt that the future of the common currency was at stake. There was a widespread understanding that without decisive action, the unthinkable might become possible: the euro zone could break-up, and the EU – at least as we know it – could disintegrate.

In the weeks before the Summit, the crisis had penetrated even deeper into the centre of the euro zone. The borrowing costs of Italy and Spain – the EU´s third and fourth largest economies – reached unsustainable levels of around 6-7 per cent. Madrid was even forced to ask for up to €100 billion from the EU rescue funds to recapitalise its tumbling banking sector. In the week of the Summit itself, the Spanish Prime Minister Mariano Rajoy announced that his country – which is trapped in a vicious circle of falling real estate prices, a tumbling banking sector, recession, and high youth unemployment – could not borrow on markets at such high costs for much longer.

In Italy, public support for the technocrat government was steadily decreasing and Prime Minister Mario Monti argued that the Summit should continue as long as was necessary to reach decisions which would help to get rising spreads under control. Just ahead of the Summit and only a couple of days before the country was about to take over the rotating Presidency of the Council, Cyprus became the fifth country to apply for a bailout, because of its banking sector's large exposure to Greece. For the first time since the outbreak of the crisis in 2010, Greece itself was not on the Summit agenda, as the new pro-EU government in Athens and its EU partners were waiting for the Troika's visit and the start of (limited) 'renegotiations'.

Outside Europe, pressure was increasing on EU leaders – especially on German Chancellor Angela Merkel – to intensify efforts to overcome the euro-debt crisis, which was threatening not 'only' Europe's but also the global economy. OECD Secretary-General Ángel Gurría accused the euro-zone countries of not using the existing instruments to the fullest, and World Bank President Robert Zoellick told Europeans to come up with a solution by the end of the Summer. Other prominent and vocal crisis commentators – including Niall Ferguson, Paul Krugman, Nouriel Roubini, Joseph Stieglitz, George Soros and others – warned of the huge economic and political consequences if the crisis deteriorated, and called on Europeans to act swiftly and forcefully.

Tensions between governments

This was the backdrop as the 27 EU heads of state and government arrived in Brussels. However, expectations were low, as tensions between Member States' governments had increased ahead of the Summit. Many observers were expecting a stand-off, with an uncertain outcome, between Italy and Spain on the one side, and Germany on the other.

The German coalition government was heavily criticised inside and outside Europe for its handling of the crisis and in particular for its resistance to agree to additional immediate crisis measures and to a common issuance of debt. As Chancellor Merkel was confronted with a growing public opposition to the EU's crisis recipe and with a tougher stance of the Constitutional Court in Karlsruhe, she warned EU partners not to overburden Germany. But outside Germany a growing number of voices argued that Berlin was 'bluffing' and that it was time to challenge and to test Chancellor Merkel.

On the eve of the Summit, Italian Prime Minister Monti argued that EU leaders would have to do everything needed to avoid a "catastrophe". There were increasing rumours that he would be ready to let the Summit burst if the European Financial Stability Facility (EFSF) or the European Stability Mechanism (ESM) were not used to purchase sovereign bonds in order to calm down markets. Mr Monti warned that his fellow citizens might otherwise become demoralised and withdraw their support for further structural reforms and efforts to reduce public expenditure.

Representatives of the German government, however, argued that Italy and Spain were "panic-mongering", and countered the claim that German resistance to a mutualisation of debt was worsening the crisis, by arguing that the major reason the crisis was still present was because of insufficient and postponed structural reforms in the countries

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most affected. In a speech to the Bundestag just before coming to Brussels, Chancellor Merkel acknowledged that the Summit could prove confrontational, but that she was ready to defend her position. She said next moves to solve the crisis should concentrate on efforts to enhance central control over national budgets and European banks. Chancellor Merkel was under particular pressure, as she faced a crucial vote in the Bundestag on the ESM and the Stability Treaty right after the end of the Summit on Friday afternoon, for which she required a two-thirds majority.

Despite these tensions, the final outcome of the June Summit proved that all those who had predicted a massive failure were wrong. In the end, EU leaders were – as so often in the past when crisis pressure increased – able to strike a compromise on three key issues: the possibility of directly recapitalising banks and providing EFSF/ESM support without a full programme; adopting a 'Compact for Growth and Jobs'; and agreeing the next steps in a process 'Towards a Genuine Economic and Monetary Union'.

However, many uncertainties, doubts and questions remain and some results are rather meagre. The EU is likely to remain in 'crisis mode' even if markets in Europe and beyond – as so often since 2010 – reacted positively to the outcome of the Summit. The subsequent analysis takes a more thorough look and draws some longer-term conclusions of the key outcomes of the European Council/Euro Summit and looks at the most likely scenario for the months and years to come (see pp.12).

Two unexpected measures – only winners no losers

After long and controversial discussions on Day 1 of the Summit, which ended with a meeting of euro-zone leaders in the early hours of Friday (originally scheduled for Friday afternoon), the leaders of the Euro 17 agreed on two measures to ease the market conditions for Spain and Italy. Following severe pressure from Prime Ministers Monti and Rajoy, who had refused to sign off the 'Growth and Jobs Pact', the Euro Summit agreed on a *direct recapitalisation of banks* and the possibility of granting *EFSF/ESM support without a full programme*.

Direct recapitalisation of banks

The first measure – which had been heavily advocated by Spain and supported *inter alia* by Italy, France, the European Commission, and the European Central Bank (ECB) – aims to break the vicious circle between banks and sovereigns by opening up the possibility of **direct recapitalisation of banks in the euro zone through the ESM**.

This could be achieved because the costs of a direct capitalisation would – contrary to an indirect bailout of banks via governments – not increase the countries concerned national debt/deficits and thus break the link between banks and sovereigns, since the ability of governments to re-finance themselves would not suffer due to a higher level of government debt.

However, even a direct recapitalisation would not be 'cost free'. The Euro Summit statement says that a direct recapitalisation would rely on "appropriate conditionality", including compliance with state aid rules, which should be institution-specific, sector-specific or economy-wide and would be formalised in a Memorandum of Understanding. The statement does not clarify what "appropriate conditionality" would mean and how it would be determined in practice. What is clear, however, is that it is the ESM Governing Board that will take the final decision to provide funding – in line with ESM guidelines – on the basis of unanimity, so every euro country has to agree to a direct recapitalisation and to the conditions attached when/if this occurs.

The direct recapitalisation of banks will only be possible after an "effective single supervisory mechanism", that involves the ECB, is established (see also below). Direct funding of tumbling banks will not be possible before then; and it is difficult to predict how long it will take to agree on the structure and competences of a banking supervisory authority, and when this new authority will start to operate. It is also unclear who will be liable for the financial assistance provided to tumbling banks – the country in which the financial institution is situated, a newly-established institution, the ESM or the bank itself. All these and other questions will have to be answered by the Eurogroup, which has been given the task of implementing the decisions agreed at the Euro Summit.

Regarding Spain, Euro leaders are calling for a rapid conclusion of the Memorandum of Understanding attached to the financial support given to Madrid. The EFSF will provide immediate assistance for the Spanish banking bailout until the ESM becomes available, which will then take over. However, it is impossible to predict when the loans to Spain will be taken off Madrid's sovereign books. What is clear, though, is that the transfer to the ESM will in the Spanish case not lead to ESM funding having seniority status over current private debt holders. However, the Spanish case will be an exception to the general rule; in future cases, ESM assistance will enjoy preferred creditor status.

EFSF/ESM support without a full programme

The second measure agreed allows euro countries, which respect their country-specific recommendations and their other commitments under the European Semester, the Stability and Growth Pact and the macroeconomic imbalances procedure, to receive **financial support from the EFSF/ESM without becoming subject to a full programme** such as that adopted by Greece, Portugal or Ireland.

The euro-zone country concerned would not have to accept additional conditions beyond the country-specific recommendations proposed by the Commission, which would (in cooperation with the ECB, but without the IMF) have to control the timely implementation of the recommendations, as laid down in a Memorandum of Understanding.

In addition, the Euro Summit statement says that the ECB has agreed to serve as an agent to the EFSF/ESM in conducting market operations. Although the exact consequence of this agreement is not yet clear, it could mean that the ECB would be able to intervene in the markets using ESM funds to assist a euro-zone country under stress and such market operations would not burden the Bank's balance sheet. The Euro 17 have, however, not agreed on any 'automatic' market-intervention mechanism as some (including Italy) had asked for.

Thomas Wieser, President of the Economic and Financial Committee, declared at the press conference of Presidents Van Rompuy and Barroso at the end of Day 1, that the procedure for countries experiencing pressure on capital markets despite "sound economic policies" should become available already during the Summer.

First assessment

The key question concerning both measures is whether they will effectively reduce market pressures on Spain and Italy. It is possible that the prospect of being able to ask for a direct recapitalisation of banks and for assistance without a full programme will ease the situation in stressed bond markets. The immediate market reactions have been positive. Yields on Spanish and Italian bonds fell sharply after this was announced. However, it is very difficult to give a sound prediction as to whether this will remain the case in the medium to long term.

Some analysts argue that the markets will continue to doubt whether the EFSF/ESM are large enough in scale to 'protect'/assist countries such as Spain and Italy. It is thus no surprise that the possibility of leveraging the available rescue funds is once again regarded as a means to increase the available bail-out money. It is, however, highly questionable whether the guarantee scheme – which was created for the EFSF in 2011 and is based on an insurance model – will work in practice.

In addition, the prospect of using ESM assistance to buy sovereign bonds in the primary and/or secondary market will probably not have the same pre-emptive effects as the possibility of a direct (securities markets programme) or indirect

‘Long Term Refinancing Operation’ (LTRO) intervention by the ECB. This is mainly because, in almost all cases, a decision to provide assistance through the ESM requires a unanimous decision of the ESM Governing Board (exception: emergency voting procedure) and markets might doubt whether other euro-zone countries, especially triple-A countries, are ready to support ESM assistance without strong conditionality.

Finally, whether countries such as Italy or Spain or others will be able to re-finance themselves on the markets at sustainable levels does not only depend on the availability and the conditions attached to the use of the rescue mechanisms. The two measures decided at the Summit can provide some relief, but both Spain and Italy and other countries will have to continue improving their competitiveness, reforming their public sectors, restructuring their banking sectors etc. in order to cut through the negative crisis spiral. These are prerequisites if these countries want to regain market confidence.

Most commentators have argued that Spain and Italy won a major victory at the June Summit by pushing Germany and its closest allies (Finland, Slovakia and the Netherlands) into the corner. Besides the fact that one can challenge this assessment (as the German Chancellor has already publicly done), it is also wrong and naïve to think in terms of ‘winners’ and ‘losers’.

All Member States and especially the euro-zone countries, have an interest in securing the stability and irreversibility of the common currency. So they all – including Germany, Finland and the Netherlands – should be satisfied if the two measures adopted at the June Summit lead not ‘only’ to a (relative) reduction of Spanish and Italian interest rates, but also to increased confidence in the EU’s ability to overcome the crisis.

The German government’s flexibility – while not abandoning key principles and guidelines laid down in rules governing the ESM and the EFSF – could be interpreted positively, as it demonstrates to the markets that there is room for compromise between euro countries if need be. However, the outcome of the Summit and Chancellor Merkel’s readiness to compromise has been widely criticised in Germany and interpreted as a sign of weakness. In the end, this could limit the German government’s room for manoeuvre in future phases of the crisis. But for the time being Chancellor Merkel can depend on the support of the two main opposition parties (SPD and the Greens).

Besides the economic and financial arguments in favour of the two short-term measures, there is another, particularly significant, political argument: Prime Minister Monti’s return to Italy with a Summit success could help him and his technocratic government continue their efforts to reform the country, thus avoiding a further deepening of the crisis in the EU’s third biggest economy. If this is the case, the Summit will have had no losers, only winners.

Compact on Growth and Jobs – political declaration with limited economic effects

Following the agreement on the two immediate crisis measures, Prime Ministers Monti and Rajoy lifted their ‘veto’ and EU leaders were able to officially sign-off the so-called ‘Compact for Growth and Jobs’ which aims to insert €120 billion into Europe’s stalled economy. The Compact is not a legal document like the Stability Treaty but a political declaration of the 27 Heads of State and Government annexed to the Summit Conclusions. It is primarily a politically-motivated document, designed to demonstrate that EU institutions and Member States are ready and willing to follow a more balanced crisis approach between ‘austerity and growth’.

The Compact was particularly significant for the new French President, François Hollande, who had fought strongly for it during his presidential campaign and in the French parliamentary elections. He and other EU leaders wanted to signal to citizens that the EU was not ‘indifferent’ to growth and was eager to create jobs, particularly for the young. Obviously, no Member State was against this objective. But the German, Finnish and Dutch governments were particularly keen on seeing this through without adopting measures based on ‘deficit spending’.

The Compact is a step in the right direction and it will have some economic effects, but its impact is likely to be rather limited. EU leaders agreed on two new elements. The first includes a **€10 billion increase to the paid-in capital of the European Investment Bank (EIB)**. These additional funds will strengthen the EIB´s capital basis and thus – according to EU estimates – increase its overall lending capacity by €60 billion. EU governments hope this amount will unlock up to €180 billion of additional investment throughout the Union.

The decision to increase the capital will now have to be taken swiftly by the EIB's Board of Governors in order to ensure that it enters into force no later than 31 December 2012. In the words of President Van Rompuy: "This will help companies to help themselves grow out of the crisis". However, it is unclear how many projects the EIB will be able to identify in the areas of energy, transport and telecoms and what the actual effects will be on growth and jobs, especially in the countries most affected by the crisis.

The second new element in the Compact relates to the so-called **Project Bonds** (not to be confused with Eurobonds or Stability Bonds), created to attract institutional investors to co-finance large European infrastructure projects. EU leaders have decided to launch the Project Bond pilot phase immediately, which the Commission estimates will bring additional investments of up to €4.5 billion for pilot projects in key transport, energy and broadband infrastructure.

Provided lessons drawn from the pilot phase are positive, the volume of such financial instruments should be developed further in the framework of the next Multi-Annual Financial Framework (2014-2020), including support to the Connecting Europe Facility (a 2011 Commission initiative to close the gap in Europe's infrastructure networks). However, it is not clear that Project Bonds will deliver the expected results, as it might prove difficult to find investors ready to co-invest in specific projects.

Other elements included in the Compact for Growth and Jobs are less new/innovative. First, the Compact reaffirms the readiness to **reallocate Structural Funds worth €55 billion** for specific projects for growth-enhancing measures in the remaining 2007-2013 financial period. Here it is, first and foremost, up to Member States to overcome national administrative obstacles in order to come up with fundable projects.

Second, in terms of enhancing European policies, the Compact contains a political declaration of intent with a **long list of measures** most of which were already mentioned in the March 2012 Summit Conclusions. The Compact calls for: (1) a deepening of the Single Market (the Commission will present respective measures in autumn 2012 as part of a second Single Market Act); (2) a well-functioning Digital Single Market by 2015; (3) further efforts to reduce the overall regulatory burden at EU and national level; (4) the full completion of the internal energy market by 2014; (5) measures to ensure that research efforts are swiftly translated into innovations to meet market demands through strengthening the European Research Area; (6) progress in the area of tax policy regarding Commission proposals on energy taxation, a common consolidated corporate tax base, and the revision of the Savings Tax Directive. With respect to a Financial Transaction Tax, the Conclusions note that several Member States intend to consider enhanced cooperation among a limited number of EU countries; (7) boosting employment for both women and men, in particular for young people and the long-term unemployed; (8) facilitating labour mobility by developing the EURES portal into a true European placement and recruitment tool; and (9) promoting free, fair and open trade.

Third, in the framework of the Compact, the EU 27 have decided to emphasise **five particular aspects when implementing the country-specific recommendations** agreed in the framework of the European Semester. These are (a) prioritising investment into future-oriented areas directly related to the economy's growth potential; (b) restoring normal lending to the economy and urgently completing the restructuring of the banking sector; (c) promoting growth and competitiveness, notably by addressing deep-rooted imbalances and going further in structural reforms to unlock domestic potential for growth; (d) tackling unemployment and addressing the social consequences of the crisis; (e) modernising public administration, in particular by tackling delays in the judicial system, reducing administrative burdens and developing e-government services.

Finally, after decades of discussion, EU leaders overcame the last hurdle to establishing a **European patent** after Member States agreed on the seat of the Unified Patent Court. France, Germany and the UK had each lobbied to host the Court and in typical EU fashion the complicated compromise splits it between them. The Court's central division will be located in Paris, while other departments dealing with more specialised fields will be based in London and Munich.

'Towards a Genuine Economic and Monetary Union' – the start of a long and complex process

During the Summit EU leaders also discussed the long-term perspectives for deepening fiscal, economic and political integration, along the lines of the report 'Towards a Genuine Economic and Monetary Union' presented by the President of the European Council and prepared in close cooperation with the Presidents of the Commission, the Eurogroup and the ECB.

The seven-page report was published in the week of the Summit. It is a significantly scaled-back version of an originally more ambitious and detailed version, which contained more concrete short-term measures to move quicker to overcome current market turmoil. Although the final version of the report has been watered down and is still contested among Member States, if implemented (which is by no means certain), it would change the nature of fiscal and economic integration in the EU, especially in the euro area.

The report aims to move towards a stronger Economic and Monetary Union (EMU) architecture over the next decade. Some commentators have argued that EU institutions and Member States should rather concentrate on the most immediate challenges of the crisis. This point of criticism is not valid. The major imbalance between the 'E' and the 'M' in EMU is one of the underlying structural reasons for the crisis. It is thus necessary to move towards a higher level of economic, fiscal and ultimately political integration, in order to eventually overcome the crisis, even if this process will be complex, cumbersome and time consuming (see also below). In addition, the process 'towards a genuine economic and monetary union' also affects the more acute challenges in the euro area, as it provides a clearer picture of where the EU is heading. This helps to break the negative spiral of uncertainty about the outcome of the crisis.

EU leaders have not agreed on the report itself but have invited the President of the European Council to develop, again in close collaboration with the Presidents of the Commission, the Eurogroup and the ECB, a "specific time-bound road map for the achievement of a genuine Economic and Monetary Union".

An interim report will be presented in October 2012 and a final report before the end of the year. According to President Van Rompuy, Member States will be constantly involved in this procedure, not only at the end of the process. The drafting of the final report, which will include concrete proposals, will follow the same procedure as the one followed with respect to the 'Treaty on Stability, Coordination and Governance in the Economic and Monetary Union' (known also as the 'Stability Treaty' or 'Fiscal Compact Treaty'). The European Parliament will be consulted in this process, but the Summit Conclusions do not specify how this involvement will work in concrete terms.

Obviously, there are still numerous open issues/questions, which need to be settled in the upcoming months, and the subsequent analysis takes a closer look at the four essential building blocks identified and described in the report: (1) integrated financial framework; (2) integrated budgetary framework; (3) integrated economic policy framework; and (4) proposals to ensure democratic legitimacy and accountability.

(1) Integrated financial framework

The first and most developed building block aims to create an integrated financial framework including three central elements: (a) banking supervision; (b) common deposit insurance; and (c) resolution framework.

Banking supervision: The June Summit has already delivered its first concrete result. It has announced a clear commitment to set up a banking supervisory mechanism for the euro area, which is also a precondition for a direct recapitalisation of banks through the ESM (see above). President Barroso has already announced that after the summer the Commission will deliver legislative proposals that will go beyond the proposals put forward in June 2012.

The 'Van Rompuy report' gives some indications in which direction things might be moving. It states that the current architecture should evolve as soon as possible into a "single European banking supervision system" at national and European levels. This should be responsible for ensuring that the supervision of banks in all Member States is equally effective in reducing the probability of bank failures and in preventing the need for intervention by joint deposit guarantees or resolution funds. The European level would be given "supervisory authority" and "pre-emptive intervention powers" applicable to all banks, while its involvement would vary depending on the size and nature of banks.

Common deposit insurance scheme: The report proposes the introduction of a European dimension to national deposit-guarantee schemes for banks overseen by the European supervisory authority. The report suggests that this would strengthen the credibility of the existing arrangements and serve as an important assurance that eligible deposits of all credit institutions are sufficiently insured.

European resolution scheme: The report proposes a scheme, which will provide assistance in applying resolution measures to banks overseen by the European supervisory body, in order to wind down non-viable institutions, in an orderly manner. The resolution scheme should – according to the report – be primarily funded by bank contributions and thereby protect tax-payers funds.

According to the report both the deposit insurance and the resolution scheme could be set up under the control of a "common resolution authority".

Although the ideas about an integrated financial framework are the most developed of the four building blocks, there are still numerous open issues/questions, which have to be discussed and settled by the end of 2012:

- **Which organisation will become the European supervisory body?** The Van Rompuy report and the Euro Summit statement indicate that key powers should be conferred on the ECB. The Commission, which originally preferred a separate agency, has already announced that it will present proposals on the grounds of Article 127.6 TFEU, which foresees that the Council may unanimously confer specific tasks relating to the supervision of credit and other financial institutions on the ECB. It is unclear whether the European Banking Authority (EBA), which has lost trust after its stress tests failed to portray a correct picture of the situation in the banking sector, will play a role in the new body.

- **Which banks would be subject to European supervision and to a European deposit guarantee scheme?** It is unclear whether the new supervisory system and the deposit scheme will involve all or 'merely' systemically-relevant banks. The German government seems particularly wary about extending European supervision to its regional savings banks, on the grounds that these are not systemically-relevant. However, the Spanish case has proven the opposite as the situation of regional banks (cajas) pushed Madrid to ask for European support to recapitalise its tumbling banking sector. In the end, a possible compromise is that national supervisors are tasked with supervising smaller banks, while European authorities would control the bigger, systemically-relevant financial institutions.

- **Which authority will control, and which sources will fund and guarantee the resolution and the deposit insurance scheme?** It is not clear which authority will be responsible for the resolution and the debt insurance scheme and how both of them will be financed, which is a key element for the credibility of the new system. The report merely states that the resolution scheme will be "primarily funded" by bank contributions and that the ESM could act as fiscal backstop to the resolution and deposit guarantee authority.

- **Are Member States ready to agree to a deposit insurance scheme?** The Euro 17 seem ready to support both the establishment of a supervisory system and a resolution mechanism, but some key Member States (including

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Germany) seem hesitant about setting up a deposit scheme. German banks argue that a European scheme might undermine the credibility of domestic deposit protection and that German tax-payers might have to pay for weaker banks in the EU´s periphery. Berlin seems rather hesitant to expose Germany to the risks of foreign banks before political safeguards have been put in place.

- **Will a European deposit guarantee scheme assure bank clients in Member States particularly affected by the crisis?** The integrated fiscal framework is designed to convince citizens that their bank accounts are safe. However, it is doubtful whether the 'bank jog' in countries like Greece or Spain will stop as long as a potential exit from the euro area or even an implosion of the euro is still on the cards.

- **Will the establishment of a 'banking union' require a change of the EU Treaties?** The report does not provide a clear answer to this question and it is probably impossible to give a sound legal prediction as long as the details of an integrated financial framework have not been spelt-out. However, it seems possible that substantial progress towards a European 'banking union' could be accomplished on the grounds of the existing legal basis.

- **What it the exact time-frame for putting an integrated financial framework in place?** Severe problems in the banking sector of many EU countries, financial-market fragmentation in the euro area, strong pressures from the markets, the need to break the negative feedback loop between sovereign and banking sector fragility, and, first and foremost, the danger of a (massive) bank run in some Member States have increased the pressure to move towards a 'banking union'. The results of the Summit indicate that work on a supervisory mechanism is likely to progress quicker than originally foreseen. However, things are less clear with respect to banking resolution and deposit insurance; these might only come at the end of a longer process, which will take time as it requires multiple successive steps.

- **Which Member States will participate in the 'banking union'?** It is unclear whether the integrated financial framework will simply cover the euro-zone countries or will go beyond them. The European Commission originally advocated a 'banking union' for all Member States and the Van Rompuy report suggests that an integrated financial framework should cover all EU Member States, while "allowing for specific differentiations" between euro and non-euro countries. The UK and Sweden have clearly stated that they would not participate in a banking union. However, other EU countries, which have not yet introduced the common currency, might want to join and it seems likely that euro-zone countries will allow them to do so. In any case, the report and the Summit Conclusions highlight that the "unity and integrity of the Single Market in the field of financial services" need to be preserved.

(2) Integrated budgetary framework

The second building block mentioned in the report is less precise, which stems largely from the fact that this is the most disputed element among Member States as it ultimately advocates some form of debt mutualisation. The German government was unhappy that this part of the report – according to their point of view – highlighted the need to collateralise debt, rather than the need to increase tighter fiscal control. However, Berlin´s criticism seems exaggerated. The report presents a balanced approach, which takes into account both the German government's opposition to a common debt issuance and the fact that a majority of euro countries favours some form of collateralisation.

The report argues that a smooth functioning of EMU requires not only swift and vigorous implementation of the measures already agreed in the framework of reinforced economic governance but also a further "qualitative move towards a fiscal union". In this respect, the report follows the underlying logic that a greater pooling of risks should be accompanied by a commensurate pooling of decision-making.

In more concrete terms, the report advocates that annual budgets and government debt levels' upper limits must be agreed in common and that the issuance of government debt beyond agreed levels would have to receive prior approval. The measures proposed in the report go well beyond the plans presented by the Commission last year ('two pack'), which would give Brussels the power to review budgets before they are submitted to national parliaments, but not the authority to make/impose changes.

Despite strong opposition from the German coalition government, the report states that the "issuance of common debt could be explored" in the medium-term perspective as an element of a fiscal union, and subject to progress on fiscal integration. The report explicitly states that steps in this direction would require "a robust framework for budgetary discipline". The report acknowledges the different options already proposed, and advocates that a partial issuance of common debt should be "criteria-based and phased", so that progress in the pooling of decisions on budgets would be accompanied with commensurate steps towards the pooling of risks.

The report argues that a fully-fledged fiscal union would imply developing a stronger European capacity capable of managing economic interdependence. Ultimately, this development could – according to the report – lead to a euro-zone level fiscal body such as a "treasury office". Finally, with respect to the EU budget, the report states that the "appropriate role and functions of a central budget" will have to be defined.

Obviously, the proposals drawn up to achieve an integrated budgetary framework need to be further developed in future weeks and months in order to provide answers to a set of key questions:

- Under which fiscal conditions will the German, Dutch and Finnish governments be ready to accept a partial collateralisation of debt? What degree of budgetary control will be sufficiently strong and compulsory enough to persuade Berlin, Helsinki and The Hague to drop their objections? Will the current German government (or others) defend its 'no' to the end? If so, will this ultimately undermine the effectiveness of the overall crisis recipe?

- Would debt mutualisation require a change in the EU Treaties or are some forms of partial/temporary common debt issuance compatible with the Union's existing legal framework? The Van Rompuy report mentions different forms of debt collateralisation including a limited mutualisation of short-term debt known as 'eurobils', or a gradual roll-over into a redemption fund along the lines proposed by the German Council of Economic Experts, which would pool any euro-zone country's debt of over 60 per cent. Thought could also be given to a less ambitious model, which limits debt mutualisation to new government debt following approval by the Eurogroup as a whole. In other words, old debt would remain national while new debt agreed in common would be collateralised.

- What kind of functions and competences would a European 'treasury office' have and who would perform these tasks – would it be the Commission or would it require the establishment of a separate institution? Would the introduction of a 'treasury office' require treaty change and would it imply a substantial increase in the EU budget? Would this 'treasury office' – or 'European Fiscal Authority' or 'European Debt Agency' – manage a common European debt issuance?

- Under which conditions will Member States be ready to surrender or rather pool sovereignty over their national budgets? Will national parliaments and the wider public accept such a loss of sovereignty? Would national constitutions have to be amended to allow for a pooling of fiscal sovereignty, and in what way?

(3) Integrated economic policy framework

The third building block dealing with an integrated economic policy framework is very vague. It calls for stronger economic integration in order to foster coordination and convergence, address imbalances, and ensure the capacity to adjust to shocks and compete in a globalised world economy, but it does not indicate how all this could be accomplished.

The report merely states that it is important "to make the framework for policy coordination more enforceable" to ensure that unsustainable policies do not risk destabilising the EMU. It acknowledges that the euro area is diverse and that policy-making at the national level is the most effective method to steer national economic policy-making; i.e. it does not call for a unified economic policy but for a higher level of economic coordination, particularly among euro-zone countries.

The report recognises that the current framework for policy coordination is insufficient. However, it does not indicate how to counter the two biggest deficits with respect to the European Semester, the Euro Plus Pact and the macroeconomic imbalances procedure: (i) Member States' lack of ownership and ambition; and (ii) the lack of a strong means of 'coercion' and 'persuasion' in policy coordination as it is based on a loose form of intergovernmental coordination.

However, despite all the criticism of the new instruments, one should acknowledge that the crisis has already had a positive impact on economic policy coordination at European level, especially among euro-zone countries. The crisis has increased the level of ownership and the degree of peer pressure. Governments – especially in the euro zone – are politically backing the European Commission and even pushing it to produce more revealing assessments and more concrete country-specific recommendations.

The euro-zone leaders' decision at this Summit to link financial assistance through the ESM with Member States' readiness and ability to implement country-specific recommendations further increases the pressure on governments to deliver in the framework of the European Semester. At the March 2012 Summit EU leaders had already called for "enhanced peer pressure" and invited the Commission to provide "transparent scoreboards" as a basis for appropriate benchmarking. The interim report and the final report will have to come up with further ideas on how to strengthen economic policy coordination. This should include also positive incentives to 'reward' Member States if they comply with the Commission's recommendations.

(4) Ensuring democratic legitimacy and accountability

Finally, the fourth building block is the weakest of all. The report merely states that closer EMU integration will require "a stronger democratic basis and broad support from citizens". The report correctly asserts that more integrated fiscal and economic decision-making between countries will require strong mechanisms for legitimate and accountable joint decision-making.

As a response to this challenge, the report proposes the close involvement of the European Parliament (EP) and national parliaments, but does not specify in concrete terms how this should be done.

It does not even list some of the new and old proposals, which have been put forward over the last couple of months including: the direct election of the Commission President; a stronger link between the 2014 EP elections and the (s)election of the next Commission President; the introduction of a 'big double-hat' combining the posts of the President of the European Council and the President of the European Commission; a reduction in the size of the Commission; the extension of EP powers especially in the area of economic and fiscal affairs; providing the EP with a right of initiative; the establishment of a special body composed of national parliamentarians to scrutinise Eurogroup activities; or the suggestion to create a special European Parliament sub-committee that only includes parliamentarians from euro-zone countries.

In addition, the report does not indicate how the process leading to a higher level of democratic legitimacy and accountability should be organised and steered. Will it require another Convention-like exercise to substantially reform the EU's politico-institutional architecture? Or do the existing Treaties provide a strong enough legal basis to increase the EU´s democratic legitimacy and accountability at both the European and national level?

The aim to ensure democratic accountability and legitimacy will require a more thorough and public debate about the EU's future politico-institutional construction. The final report, due to be delivered in December 2012, should not attempt to provide a comprehensive plan on re-designing the EU's basic institutional architecture. Rather, following the example of the Laeken Declaration in 2001, it should attempt to identify the core questions and issues and describe the process how to move the Union towards a higher level of *sui generis* economic and political integration. Following the final report, a 'reflection group' could be asked to provide some further ideas and proposals.

What next? Ambitious 'muddling through'!

Following the latest escalation of the crisis and the decisions taken at the June 2012 Summit, especially EU leaders' commitment to embark on a road 'Towards a Genuine Economic and Monetary Union', it is time to ask what might and what should happen next. To answer this question, one should look at the most likely scenario, although nobody can under the present circumstances really make a sound prediction how the crisis will end and how it will affect Europe both inside and in relation to its global role.

More than two-and-a-half years after the outbreak of the crisis the EU and its members are still struggling to get ahead of the curve. The crisis has gradually deepened and extended from the periphery of the euro zone to its core. This has happened despite EU institutions and governments, and especially euro-zone countries, having enhanced European economic governance in ways which would have seemed inconceivable only some years ago.

Whatever the final outcome, the crisis will fundamentally shape the future of European integration. Future historians will look back and assert that the euro crisis was a historically-decisive moment. In a worst-case scenario, the sovereign debt crisis could lead to an implosion of the euro zone, which in turn could provoke an overall disintegration of the EU in its current form.

This scenario (still) seems rather unlikely – as all Member States, both inside and outside the euro area, seem keen to avoid the enormous economic, financial, political and social costs that would result. But the danger of a fundamental disintegration has increased over time and, today, one cannot exclude this possibility if things get out of control, if the euro crisis reaches a point of no return as the 'crisis snowball' keeps on growing and triggers an avalanche which has the potential to bury the European project underneath it.

Fortunately, the 'Titanic' scenario is not the most likely. But it is also unlikely that in the near future the EU of 27/28 will make one giant leap towards a 'United States of Europe', a genuine federal entity in which Member States agree to surrender national sovereignty both in the area of fiscal and economic affairs and in other fields such as foreign and security policy or justice and home affairs.

The last two-and-a-half years and the June 2012 EU Summit indicate that 'muddling through' will remain the EU´s dominant mantra for the foreseeable future. However, contrary to the past, the increasing (existential) pressures from the euro crisis and the constant scrutiny of the EU by markets and citizens will require bold policy responses that go well beyond the lowest common denominator.

At the end of the day, 'ambitious muddling through' will most likely lead to a higher level of *sui generis* economic and fiscal integration – especially among euro-zone countries – including a binding coordination of national budgets, a higher level of economic coordination, and eventually also some (limited) form of debt collateralisation. Resolving the crisis will require 'more Europe'. But it is impossible to predict the final outcome, as this will be the result of a very delicate and difficult compromise at the end of a complex process that bridges highly divergent and heterogeneous positions both within the EU and among euro-zone countries.

The initial steps towards a 'banking union' taken at this Summit prove, once again, that euro countries are likely to progress faster than the rest. But chances remain high that the deepening process and membership in the euro zone will remain open to other Member States. EU countries will be keen to avoid a deep split within the Union between 'ins', 'pre-ins' and 'outs', which could have (very) negative repercussions for the EU including on the Single Market, the cornerstone of European integration.

In the next phase and in order to save time given the urgency of the crisis, the process towards a higher level of fiscal and economic integration might require particular (intergovernmental) arrangements between euro-zone countries, but these should be open to non-euro countries which are ready and able to join in.

In the coming months the President of the European Council in cooperation with the Presidents of the Commission, the Eurogroup and the ECB, should identify which additional steps should and could be taken towards an economic, fiscal and banking union, on the basis of the existing EU Treaties and which steps might require some form of treaty change either through the ordinary or the simplified revision procedure.

In order to save time, some of the elements, which are not enforceable on the grounds of the present EU Treaties, might require additions to the Stability Treaty or even another intergovernmental treaty/agreement. This should not be a goal in itself, but might be a necessary evil to avert the danger of a euro implosion. In any case, everything should be done to include the existing EU institutions in the arrangements laid down in an intergovernmental treaty/agreement. The Stability Treaty has shown that this is do-able even though it is a legal and institutional challenge.

However, in order to regain institutional coherence, legal certainty and democratic accountability, one should at some not too distant point in time incorporate the core elements of these intergovernmental agreements/treaties into the Union's legal framework. Interestingly enough, the Stability Treaty already includes a 'repatriation clause' according to which signatories will, within five years following the entry into force of the Treaty (i.e. by 2018), take the necessary steps to insert the substance of that intergovernmental treaty into the EU's legal framework.

The incorporation of the core elements of the intergovernmental treaties/agreements and further progress towards a 'Genuine Economic and Monetary Union' will ultimately require a reform of the existing EU Treaties on the grounds of a process that involves not only EU governments but also other key actors at European and national level, particularly the European Parliament and national parliaments (Convention).

Given the need for a 'grand bargain' between all Member States, EU treaty reform is unlikely to be limited to issues related to economic and fiscal integration. It will most probably involve other elements related, for example, to foreign and security policy or justice and home affairs. This promises to be a very complicated exercise considering the increasing heterogeneity and the antagonistic views about the perspectives of European integration in an EU 27/28.

The outcome of this process would have to be followed by an intergovernmental conference tasked to finalise the new Treaty, which will then have to be ratified in all Member States. The latter will be particularly challenging given the experience with the Constitutional Treaty and the increasing frustration of EU citizens *vis-à-vis* the Union and its crisis recipe.

Moving towards a higher level of economic, fiscal and political integration will also necessitate adapting national constitutions. The ratification of the new EU Treaty and the change of national constitutions would inevitably lead to referenda in a number of Member States. The outcome of these referenda will be highly uncertain; but one will have to take this risk. However, the danger of a euro implosion will increase the chances that a majority of Europeans will vote 'yes'.

The above-described process will be a long, bumpy and sometimes risky road. The 'ambitious muddling through' scenario will probably end at a destination, which will look very different from how we envisage it today. But before one embarks on that inevitable, but uncertain journey, EU institutions and Member States (actively supported by the ECB) will in the immediate future have to continue working hard to tighten a strong-enough safety net, capable of protecting the euro and the Union itself from hitting the ground when things get rough in the years to come.

Immediate economic, fiscal and market pressures deriving from the crisis are likely to remain. In addition, the EU and its members will have to cope with the collateral damage caused by the crisis, i.e. unintended and unexpected consequences of the euro-debt crisis at both the European and national level. These include: an increasing national focus and anti-EU populism, mounting socio-economic challenges in an increasing number of Member States, a growing 'democratic deficit' at both the national and European level, a poisoned atmosphere among EU countries and even between national societies, and the lack of pro-active leadership coalitions pushing in the same direction. All these collateral damages could lead to a standstill, which could challenge future prospects and past accomplishments of European integration.

Under these circumstances, 'ambitious muddling through' is not only the most likely, but also the most promising scenario. But muddling through will not be easy and will not allow time for complacency as the EU is most likely to remain in crisis mode for some time to come.

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