EPC
EUROPEAN POLICY CENTRE

17.12.2012

Post-Summit Analysis

Steps but no roadmap towards GEMU – the results of a disappointing summit

Janis A. Emmanouilidis

Summary

The 13-14 December European Council was disappointing as it failed to live up to the expectations raised and the objectives set earlier in the year. EU leaders were not able to agree on a long-term and ambitious roadmap towards the completion of EMU. The EU 27 rather gave the impression that they could take advantage of the relative calm in the markets and take a breather. But this Post-summit Analysis by Janis A. Emmanouilidis argues that the euro zone is still far away from reaching the comfort zone and that complacency could undermine the regained confidence in the euro and the future of the EU. The December Summit has shown that progress towards a 'genuine EMU' will not be possible without a rapprochement between Germany and France; but there is a good chance that the political preconditions for reconciliation between Berlin and Paris will be more promising after German federal elections in September 2013.

Full report

The European Council meeting on 13-14 December was a disappointment as it failed to meet the expectations raised and the objectives set earlier in the year. Ironically, it took place less than 24 hours after EU finance ministers had reached a breakthrough on the legal framework to create a European Central Bank-based single supervision system – a major step on the way to a European banking union.

The December Summit was originally supposed to set the EU on course to establishing a "genuine Economic and Monetary Union" (GEMU) on the basis of a "specific and time-bound roadmap" as specified in the June 2012 European Council Conclusions. However, EU leaders failed to draw up a detailed plan. Instead they decided to put off major decisions on how to build closer fiscal, economic and political integration – at least for the time being.

The Summit results are a sign of distrust and a heavy blow to the major EU institutions' efforts to structure the process towards deepening financial, fiscal, economic and political integration in the months and years to come. EU leaders did not endorse the time frame and the stage-based process proposed by European Council President Herman Van Rompuy in a detailed report prepared in close collaboration with the presidents of the European Commission, the Eurogroup and the European Central Bank (ECB), published on 5 December.

At the Summit EU leaders refused to define an ambitious timeline. By backing away from higher aspirations, they gave the impression that they wanted to take advantage of the current relative calm in the markets and to take a breather after a year of intense crisis management. Instead of taking up Van Rompuy's more forward-looking approach, which had incorporated the Commission's even-more ambitious "Blueprint for a deep and genuine EMU" (published on 5 November), they decided to concentrate on more immediate concerns.

The evening discussions on Day One of the European Council focused mainly on two areas: strengthening the banking system and enhancing economic policy coordination. With respect to

establishing a banking union, the EU 27 made some progress regarding a "single supervision system" (SSM) and setting up a single banking resolution mechanism, although key challenges still remain in relation to the SSM and other elements of a banking union.

Following strong opposition from the German, Dutch and Finnish governments, EU leaders scrapped one of the key proposals included in the Presidents' Report aiming to provide financial assistance to euro countries facing economic shocks. In terms of enhancing economic coordination, EU leaders discussed the introduction of "contractual arrangements" to be supported by a new "solidarity mechanism"; but many details still need to be clarified by June 2013.

Day Two of the Summit was mostly devoted to two EU external relations issues: First, the EU's Common Security and Defence Policy (CSDP). In preparation for a more thorough debate scheduled for the December 2013 European Council, EU leaders gave the High Representative until September 2013 to develop proposals and actions to strengthen the CSDP and improve the availability of civilian and military capabilities. On the second issue, the deteriorating situation in Syria, the European Council asked the Foreign Affairs Council to look at all options to "support and help the opposition and to enable the greater support for the protection of civilians". EU leaders reiterated that political transition is necessary in Syria "towards a future without President Assad and his illegitimate regime".

This analysis of the December European Council will examine five key issues: (1) stepping stones and stumbling blocks towards a European banking union; (2) the inability to set an ambitious timeline for far-reaching reforms; (3) the decision to scrap the idea of a shock absorption mechanism; (4) the potential effects and open questions about introducing contractual arrangements and a new solidarity mechanism; and (5) the inability to make any concrete progress to enhance the EU's democratic legitimacy and accountability and the issue of treaty change.

It will finish with an assessment of the situation after the Summit and the prospects for 2013 and beyond.

Stepping stones and stumbling blocks towards a European banking union

EU leaders heralded the fact that on the eve of the Summit the 27 EU finance ministers had reached a compromise on most of the details for establishing an ECB-based single supervision mechanism (SSM). The heads of state and government have asked the Cyprus Presidency to negotiate with the European Parliament (EP) with a view to adopting the necessary legislation before the end of the year.

The European Central Bank, which has no direct supervisory experience, is expected to start setting up the SSM in the second quarter of 2013. It was agreed that it would assume its supervisory tasks within the SSM on 1 March 2014 (or 12 months after the entry into force of the legislation). Following a compromise struck between the 27 member states (especially between Germany and France), the ECB will not oversee all European banks (as the Commission had originally foreseen and strongly supported by France). Instead it will 'only' enjoy direct oversight over banks already receiving state support, and financial institutions whose balance sheet exceeds €30bn or which equal more than 20 per cent of a country's GDP – thus excluding the German banks *Sparkassen* and *Landesbanken* from direct ECB supervision. In practice, this means the ECB will have direct oversight 'only' over roughly 150-200 of the 6,000 European banks, but it will have the right to extend its supervision to any bank it deems necessary – although it is not fully clear under what conditions it would be able/allowed to do so.

The ECB's monetary tasks shall be strictly separated from supervisory tasks in order to eliminate potential conflicts of interests between monetary policy and banking supervision. To this end, a separate supervisory board will be set up within the ECB. However, some observers and prominent actors – including the president of the German *Bundesbank*, Jen Weidmann – are still rather critical as to whether this new set-up will be capable of clearly separating the two tasks.

Non-euro countries wishing to participate in the SSM will be able to do so and will have "full and equal voting rights" in the supervisory board. The two biggest banking centres outside the euro zone, the UK and Sweden, together with the Czech Republic, have already decided to remain outside the banking union, although Stockholm has kept the option open of joining at a later stage. The European Banking Authority (EBA), which includes all 27 EU countries, will retain its competence for developing the single rulebook and ensuring the convergence and consistency of the national supervisors. New voting rules concerning the EBA will ensure that decisions can be blocked if they are not passed by a simple majority of non-euro countries.

It is a major achievement that the 27 EU governments have met the year-end deadline for the initial stage of a banking union. This seemed almost unthinkable a year ago and is a major improvement compared to the current system, which is based solely on national supervisors.

Establishing the SSM could shore up confidence, encourage and restore 'normal' cross-border lending and, over time, reduce the high borrowing costs for banks (and companies) in Europe's periphery. Most bankers, investors and analysts have welcomed the plan to hand over direct supervision to the ECB as a major step towards overcoming one of the key deficits of Economic and Monetary Union.

However, this is only a first step and there are at least three key challenges related both to the SSM and to other elements of a European banking union:

- *Uncertainties concerning direct bank recapitalisation:* The most contested issue has been, and remains, how and when a direct recapitalisation of banks through the European Stability Mechanism (ESM) would work in practice. The December Summit Conclusions reiterate the imperative to break the vicious circle between banks and sovereigns. Going beyond the June 2012 Euro Area Summit's statement and the October 2012 European Council Conclusions, the December Conclusions state that an "operational framework" should be agreed as soon as possible in the first semester of 2013, so that when an "effective" SSM is established, the ESM will be able to directly recapitalise banks.

  However, there are still no clear details about the time frame or which banks might be recapitalised through the ESM. It is by no means certain what "effective" will mean in practice and who (the ECB?) will ultimately determine whether and when the system has reached an adequate level of operational capacity. German Finance Minister Wolfgang Schäuble has declared that direct recapitalisation will not be possible well into 2014. The new Dutch Finance Minister Jeroen Dijsselbloem (likely to be the next Eurogroup President following Jean-Claude Juncker's decision to resign), even raised the possibility that the Netherlands might not be ready to cede control to the new supervisor by April 2014.

  Another issue in need of clarification is which banks and which assets would be eligible for direct recapitalisation. Would direct recapitalisation include or exclude 'legacy assets'; i.e. would the ESM be barred from directly supporting financial institutions, which got into trouble before the new European supervisory system was put in place? German Chancellor Angela Merkel has repeatedly declared that there would be no "retroactive direct recapitalisation". Should this be the case, the Spanish, Irish, and/or Greek banks that are already in trouble would not be able to ask for retroactive direct assistance from the ESM. This could strongly undermine the overall objective of breaking the 'vicious circle' between banks and sovereigns.

- *Single Resolution Mechanism:* Establishing a single supervision mechanism is just the first and maybe the 'easiest' step towards a banking union. This needs to be complemented by other key innovations, including a single resolution mechanism (SRM) that provides single European rules and means to wind down failing banks supervised by the ECB, ultimately moving the power to force losses on bank owners and creditors to the European level.

The Commission has announced that during 2013 it will submit a proposal for a single resolution mechanism for member states participating in the SRM and the Summit Conclusions call on the co-legislators (the Council and the European Parliament) to adopt the relevant legislative acts before the end of the current parliamentary cycle, i.e. before June 2014. However, it is by no means certain that this timetable will materialise as there is now less acute pressure from the crisis and as there are federal elections in Germany in September 2013 – where the plan to set up a SRM is rather unpopular.

It will be more difficult to reach a compromise on the SRM than it was to agree to create the SSM: establishing and applying an SRM could involve taxpayers' money; money that then might be spent on resolving banks in other member states. But an ECB-based SSM without a single resolution mechanism could mean that that the European Central Bank would have to rely on national bank resolution arrangements, which could significantly tie the ECB's hands and undermine the credibility of the entire system. However, ECB President Mario Draghi is confident that a European resolution authority "will probably be in place by the time the SSM takes up its responsibilities".

It is not clear where the financial means necessary for a single resolution mechanism will come from. The Summit Conclusions merely state that the mechanism should be "based on contributions by the financial sector itself" and "include appropriate and effective backstop arrangements". However, it will take years to build up a sufficiently-equipped "European resolution fund" (as the Presidents' Report proposed) based solely on contributions from financial institutions which directly participate in the SSM. In the meantime, the ESM could function as a backstop by providing a credit-line to the single resolution authority. However, this cannot be a permanent alternative because of the many uncertainties associated with this solution.

- *No single deposit guarantee scheme:* Original plans/ideas about a European banking union had foreseen not only the creation of a SSM and an SRM but also setting up a single European deposit guarantee scheme. However, the European Council Conclusions merely urge co-legislators to agree on the proposals for the so-called Deposit Guarantee Scheme Directive before June 2013, which foresees the harmonisation of national deposit guarantee schemes.

  Following strong opposition in numerous member states – and especially from the German savings banks – the idea of establishing a single European deposit guarantee scheme has fallen off the agenda. EU and member states' officials hold that an EU-wide deposit scheme would not be necessary, if there is a strong supervisory mechanism and bank resolution mechanism in place. However, it is by no means certain that confidence in countries most hit by the banking crisis will return and attract bank clients to bring back their money to their (national) bank accounts in the absence of a single European deposit guarantee scheme.

No long-term roadmap towards GEMU

As a result of opposition from a number of member states (led by Germany and the Netherlands), EU leaders failed to agree on a specific and time-bound roadmap specifying the process and the concrete steps towards the completion of a genuine EMU. Contrary to earlier drafts, the final version of the Summit Conclusions makes no reference to a stage-based process. In this respect, the results of the December European Council fall way behind the Presidents' Report's proposals to structure the process from now until after 2014 along three stages: *Stage 1 (2012-2013):* "Ensuring fiscal sustainability and breaking the link between banks and sovereigns"; *Stage 2 (2013-2014):* "Completing the integrated financial framework and promoting sound structural policies"; and *Stage 3 (post-2014)*: "Improving the resilience of EMU through the creation of a shock absorption function at the central level".

Rather than presenting a roadmap for the coming years, EU leaders were merely able/ready to set out the next, more immediate steps towards deepening the EMU. The European Council has asked the president of the European Council,

in close cooperation with the president of the European Commission (but not the presidents of the Eurogroup and/or the ECB!), to present possible measures and a time-bound roadmap to the June 2013 European Council on four issues. These are: (a) *ex ante* coordination of major national economic policy reforms; (b) the social dimension of the EMU, including social dialogue; (c) the feasibility and modalities of mutually-agreed contracts for competitiveness and growth; and (d) "solidarity mechanisms" that can enhance the efforts made by member states which enter into contractual arrangements.

According to senior German officials, this roadmap should concentrate on more immediate issues and not on what the EMU might look like in 2020, although this is contrary to what they and other governments were saying only a couple of weeks earlier. Speaking at the European Parliament in November 2012, the German Chancellor said the December Summit should aim to come up with a master plan and an ambitious roadmap/timeline on what to do in the upcoming two to three years.

The Summit Conclusions explicitly mention that the process in the upcoming months shall include close consultations with the member states. This seems to reflect the fact that some (key) member states were not convinced by the content, quality and direction of proposals/ideas included in the Presidents' Report and felt that they had not been adequately consulted. In her press conference after Day One of the Summit, Chancellor Merkel underlined that future meetings of the European Council until June 2013 (except for the one dealing with the Multiannual Financial Framework) should deal with the four specific issues and that national parliaments should be fully involved, because at the end of the day they would be asked to play a key role in enhancing economic coordination, for example in the context of the new contractual arrangements (see also below).

No shock absorption mechanism – at least not now!

The Summit not only fell short of defining a long-term roadmap; faced with strong opposition from numerous member states, including first and foremost Finland, Germany and the Netherlands, the final Summit Conclusions also left out a core proposal from the Presidents' Report and the Commission's Blueprint calling for a new mechanism to facilitate the adjustment of country-specific economic shocks.

In more concrete terms: the Presidents' Report had proposed the introduction of a fiscal capacity in different phases. In its first phase (2013-2014) structural reforms could, in specific cases, be supported through "limited, temporary, flexible and targeted financial incentives" as member states enter into contractual arrangements with the EU institutions.

This proposal was along the lines of an idea originally suggested by the German government and supported by a large number of other EU capitals to set up a "solidarity fund" to support concrete measures/projects to strengthen competitiveness and growth in individual member states. In other words, the fund could be used as a 'carrot', i.e. as limited and targeted financial support to help countries carry out reforms that are conditional on fulfilling a country-specific contract developed in the framework of the European Semester (see also next section).

In another proposal that went well beyond the idea of a solidarity fund, the Presidents' Report foresaw that in the second phase (after 2014) a more far-reaching and larger fiscal capacity would be created to facilitate countries to adjust to major economic shocks. According to the Presidents' Report, this fiscal capacity – which was already mentioned in President Van Rompuy's interim report published in October – could take the form of a "well-defined and limited" insurance-type mechanism between euro-area countries that would cushion the impact of country-specific shocks and thereby help prevent contagion across the euro zone and beyond by providing a degree of automatic stabilisation at European level.

This proposal, which was supported by a majority of euro countries, including Luxembourg, France, Spain, Italy and other southern member states, assumes that cushioning economic shocks could prevent contagion in the euro zone, thereby contributing to crisis prevention and making future ESM interventions less likely. According to the Presidents' Report, contributions from – and disbursements to – national budgets would fluctuate according to "each country's position over the economic cycle," i.e. over time all member states would profit from the proposed insurance scheme.

The Presidents' Report proposed two possible approaches for applying the shock absorption mechanism: (1) a "macroeconomic approach" in which contributions and disbursements would be based on fluctuations in cyclical revenue and expenditure; or (2) a "microeconomic approach" more directly linked to specific public functions sensitive to the economic cycle, such as unemployment insurance.

Earlier drafts of the Summit Conclusions included both versions of a fiscal capacity (solidarity mechanism and shock absorption mechanism). In the end, however, the proposal to further examine the idea of a shock absorption mechanism was scrapped following solid member-state opposition.

The Dutch and the German governments were strongly against the idea, arguing that it would not help to solve the crisis nor its roots causes, which, according to Berlin and The Hague, are the result of irresponsible fiscal policies and the loss of competitiveness in the periphery of the euro zone. In the words of Chancellor Merkel, the shock absorption capacity was a "badly disguised transfer" mechanism; something to which Berlin and other net payers have always been strongly opposed. These kinds of transfer mechanism would – according to them – set the wrong incentives and ultimately undermine readiness to reduce public deficits and increase competitiveness through structural reforms.

In contrast, the Presidents' Report argues that the shock absorption mechanism should/must not lead to unidirectional and permanent transfers, but that each euro country "as it moves along its cycle" would over time be both a net recipient and net contributor to the scheme. The Report also argues that there are ways to avoid the risk of moral hazard inherent in any insurance system, which could undermine incentives for fiscally-sound national policymaking or the need to address structural economic weaknesses. Finally, a fiscal capacity to facilitate adjustment to economic shocks would only be introduced in the final phase of the process towards a genuine EMU, when other mechanisms to ensure fiscal discipline and economic convergence were already in place.

The reassurances in the Presidents' Report have not persuaded critics of the shock absorption capacity, who believe that the mechanism would ultimately lead to a 'transfer union' and/or 'social union' with immense financial transfers from the 'rich north' to the 'poor south'. Dutch, Finnish and German government representatives were particularly irritated about the expectation that huge amounts of money would, for example, be used to support unemployed people in Greece, Spain or Portugal, or to cushion external shocks in countries that are unable to devaluate their currencies. They felt that creating a new fiscal capacity should not involve more than €10-20 billion, i.e. much less than the amounts probably required for a shock absorption mechanism.

However, the idea is not dead, despite strong opposition from key member-state governments. During his joint press conference with Commission President José Manuel Barroso on Day One of the Summit, President Van Rompuy reaffirmed that the heads of state and government had not tasked them with working on the possibility of setting up a mechanism to deal with asymmetric shock by June 2013. However, he said that the Commission was always free to put proposals on the table, and that "without having a formal task we can continue to examine these proposals" although they are not on the agenda for June 2013. President Barroso added that "no doors were closed," although member states had decided to concentrate on what could be done in the more immediate future.

Contractual arrangements with 'carrots' – more questions than answers

Despite the controversies surrounding the shock absorption mechanism, the vast majority of EU leaders support the introduction of "limited, temporary, flexible and targeted financial incentives" linked to contractual arrangements between member states and the European Commission. Although not explicitly mentioned in the Summit Conclusions, President Barroso has announced that the Commission will present concrete proposals and the Commission's Blueprint already includes some more concrete ideas/suggestions.

The idea that all member states should enter into "individual arrangements of a contractual nature" with the EU institutions is a way of promoting the implementation of structural reforms by enhancing national ownership and providing financial incentives. The Summit Conclusions state that all euro countries should become engaged and non-euro member states may also choose to enter into similar arrangements.

The key innovation is to offer financial support to member states which carry out reforms. Unlike in the past, this approach does not rely simply on peer pressure or fines and sanctions. It is based on concrete incentives which could both promote the implementation of country-specific reforms and increase the political ownership of national reform programmes agreed at EU level in the framework of the European Semester. In the past, these programmes have often ended up in the drawers of national public administrations, despite all the time and energy invested at both the national and European level in working out country-specific recommendations and national reform programmes.

In more concrete terms, financial incentives through a new solidarity mechanism/fund (or "Convergence and Competitiveness Instrument" as the Commission calls it) could be used to either (i) financially cushion the negative effects of certain structural reforms, including for example an increase in (youth) unemployment (as the French intend to do), or (ii) to (co-)finance specific projects to increase the competitiveness of the country concerned (according to the German government's intentions).

In principle, the plan to put contractual arrangements in place linked to financial support is a promising one, which needs further exploration over the next couple of months. Among the many issues which need to be addressed and clarified by June 2013 are the following:

- What is the legal basis in the EU Treaties for these contractual arrangements, or would the introduction of such contracts require a treaty amendment?
- Who would conclude these arrangements on behalf of the EU – the European Commission, the Eurogroup and/or the Council?
- Would all countries participating in the new mechanism (euro and non-euro) be obliged to sign and ratify contractual arrangements?
- Will the European Parliament be involved in the process, and if so, how?
- Who would take decisions about disbursing financial assistance? And on what conditions and on what kind of parameters (competitiveness/fiscal pressures) would these decisions be taken?
- Would all countries (euro and non-euro) which have concluded a contractual arrangement have the right to ask for financial support from the new solidarity mechanism/fund, or would financial support be limited to member states with severe economic (adjustment) problems?
- Who would be responsible for managing the solidarity fund (Commission and/or the Eurogroup) and would this be part of the EU budget (part of the European Social Fund?) even if it is not included in the Multiannual Financial Framework?
- How much money would be required, and where would it come from (the Financial Transaction Tax; national contributions and/or borrowing in capital markets)? Would €10-20 billion *per annum,* as Chancellor Merkel has for example suggested, be sufficient to finance the new mechanism?
- What happens if a country does not comply with a contractual arrangement? Will there be sanctions tied to the new mechanism in cases of non-compliance?
- When would the contractual arrangements and the solidarity mechanism be in place – before or after 2014?

Besides the contractual arrangements, the Summit Conclusions include a proposal to enhance economic policy coordination: member states which have signed and ratified the Treaty on Stability, Cooperation and Governance (TSCG; also known as the fiscal compact treaty) will be invited to ensure that all the major economic policy reforms they plan to undertake are discussed *ex ante* and, where appropriate, coordinated between member states. The Commission has announced that it will come up with respective proposals to improve the operation of the European Semester.

Democratic legitimacy, accountability and treaty change – nothing concrete, yet!

A quick glance at the Summit Conclusions shows that 'suggestions' related to the fourth building block of a genuine EMU, designed to enhance democratic legitimacy and accountability, are once again very weak and vague.

The Conclusions simply reiterate the objective "to ensure democratic legitimacy and accountability at the level at which decisions are taken and implemented," and that any steps towards strengthening economic governance will need to be "accompanied by steps towards stronger legitimacy and democratic accountability". At national level, moves towards further fiscal and economic integration would require that member states "ensure the appropriate involvement of their parliaments," but the Conclusions do not specify any details. According to the European Council, further integration of policymaking and further pooling of competences at EU level must "be accompanied by a commensurate involvement of the European Parliament".

The only 'new', more concrete proposal – that cooperation between the European Parliament (EP) and national parliaments could "take the form of a conference of representatives of the relevant committees" of the EP and national parliaments – was included in earlier drafts but not in the final version of the Summit Conclusions. The Conclusions now merely state that the European Parliament and national parliaments will determine the "organisation and promotion of a conference of their representatives" to discuss EMU-related issues.

The Presidents' Report and the Commission's Blueprint went (somewhat) further than the Summit Conclusions. The Presidents' Report, for example, argues that national parliaments are "not in the best position to take [the Union's common interest] into account fully". A further integration and pooling of competences at EU level should, thus, "first and foremost be accompanied with a commensurate involvement of the European Parliament". As for national parliaments' involvement in the framework of the proposed contractual arrangements, the Presidents' Report proposes that member states should ensure the "appropriate involvement of the national parliaments" in the context of the European Semester.

The Commission's Blueprint is more concrete than the Presidents' Report and refers to the creation of a "Political Union". It suggests that in the short term and on the basis of the current EU Treaties, the focus should be on practical measures, in particular those to foster parliamentary debate in the European Semester, such as involving the EP in the discussion on the Commission's Annual Growth Survey. In the context of Treaty reform and conferring further supranational powers to the EU level, "steps should be considered to ensure a commensurately stronger democratic accountability".

Taking up a key argument used also by the European Parliament, the Blueprint states that the EP is the only parliament "for the EU and hence for the euro"; to put it more bluntly, the Commission commits itself politically to the EP and thus indirectly rejects proposals for a new parliamentary institution/configuration outside the European Parliament's framework. Finally, the Blueprint suggests that a further way of strengthening the EU's legitimacy is to extend the competences of the European Court of Justice.

However, neither the Summit Conclusions nor the Presidents' Report list or evaluate any of the many proposals that have been put forward and discussed over the last couple of months. These include *inter alia:* directly electing the Commission President and/or the European Council President; a stronger link between the outcome of the 2014 European elections and the (s)election of the next Commission President; introducing a 'big double hat' to combine the posts of European Council and European Commission President, or putting in place a semi-permanent president of the Eurogroup. Other proposals are to combine the posts of Eurogroup President and Commission Vice-President responsible for economic and monetary affairs; substantially reducing the size of the Commission; (partially) selecting Commissioners from the ranks of the European Parliament; giving the EP a right of initiative and introducing flexible EP configurations (at plenary or (sub-)committee level).

There are also suggestions to distinguish between parliamentarians from euro/non-euro countries; to give member states more proportional representation in the EP; to establish a special body composed of national (and European) parliamentarians; arranging for national ministers to appear in the EP to explain structural reforms underway in their countries; organising hearings of EU Commissioners in national parliaments; and requesting representatives of the new ECB supervisory board to appear in national parliaments.

None of these proposals are being put on the table and discussed openly in the framework of the current process between EU governments and institutions aimed at deepening EU integration. There are three main reasons for this: first, proposals to enhance democratic legitimacy and accountability cannot be discussed until there is more clarity about the concrete

measures/innovations that will be introduced in the three other building blocks (integrated financial, fiscal and economic frameworks). Second, President Van Rompuy and the three other presidents do not want to enter into tricky debates about the EU's future institutional setting, as this might upset many of the member states and institutions involved in the process. Third, any debate about a reform of the Union's institutional structure would further spur the discussion as to whether and how the EU Treaties will have to be amended to implement some of the potential institutional reforms.

Concerning a possible amendment of the current EU Treaties, the Summit Conclusions do not provide any clarity as to whether some of the innovations required for an 'EMU 2.0' will need (limited) treaty change. An earlier draft of the Conclusions included the provision that a "progressive pooling of economic sovereignty" between member states "may imply a change of the Treaties". However, the final version does not include any reference to treaty change.

Bearing in mind the negative experience surrounding the rejection of the Constitutional Treaty in 2005 and the difficulties related to ratifying the Lisbon Treaty in Ireland, most governments (still) seem (very) keen to avoid a discussion about any kind of (major) treaty change. However, the discussions are gaining momentum, as some innovations designed to deepen economic and fiscal integration would probably require changing the EU's primary law at some point in time.

The Commission's Blueprint goes furthest by listing a number of concrete cases including the following, all of which would require treaty changes:

- introducing a Debt Redemption Fund;
- the common issuance of short-term government debt with a maturity of up to one to two years (so-called Eurobills);
- moves towards tighter control of national budgets, e.g. by setting up a European right to require a budget revision;
- deeper coordination in the field of taxation;
- a further strengthening of the Eurogroup;
- strengthening democratic accountability over the ECB insofar as it acts as a banking supervisor, and;
- steps to reinforce the position of the Vice-President for Economic and Monetary Affairs and the euro.

Completing EMU and introducing major institutional innovations to enhance democratic legitimacy and accountability will require amending the existing EU Treaties at some point in time. It is also likely that one of the crucial actors, i.e. the German government, will press for a reform of the Union's primary law in order to provide the legal grounds to further strengthen the EU's ability to control national budgets (e.g. through a 'super Commissioner' able to veto budgets) and in order to appease the Constitutional Court in Karlsruhe (*Bundesverfassungsgericht*), which is already rather critical over the legality of recent innovations related to strengthening European economic governance both with respect to the compatibility with EU Treaties and the German *Grundgesetz* (German Basic Law). In contrast, French President François Hollande (and others in France) seems eager to avoid any treaty change that would force a referendum and could also expose major divisions in the French Socialist Party.

Where do we stand after the Summit and what should we expect in 2013 and beyond?

Following this more detailed and technical analysis of the December 2012 European Council, the final part of this Post-summit Analysis will address some more fundamental questions: what are the core lessons one can draw from the December Summit? Where does the EU stand after this European Council and at the end of 2012? And lastly, what can we expect in 2013 and where might we be heading?

Core lessons and challenges

First, the fact that the December Summit was far behind expectations but did not provoke negative reactions in the markets is another positive indication that the prospects for the future of the common currency look much more promising than before the summer, when the EU and especially the common currency area were in 'deep crisis mode'. However, the euro zone is still far away from reaching the comfort zone: in the words of President Van Rompuy at the start of the European Council meeting: "the worst is now behind us, but of course much still needs to be done".

EPC
EUROPEAN POLICY CENTRE

The ECB's decision to provide the 'big bazooka' through its conditionality-based OMT (Outright Monetary Transactions) programme, the substantially-reduced risk of a country leaving the euro zone, and the EU's announcement and subsequent steps to overcome the incomplete construction of EMU have increased confidence in the common currency and reduced the danger of a systemic meltdown. The start of ESM operations, the financial assistance to Spain, the long-awaited agreement on Greece, and progress towards a banking union showcase that EU governments and institutions can take decisions even if progress is incremental, takes time and in the end leads to (highly) complex institutional and legal constructions.

However, there is no room to sit back and relax. Despite promising signs, the crisis is not over and the financial, economic, social and political situation remains fragile at both European and national level, especially in those countries suffering most from the crisis. The situation of many national banking sectors remains difficult; the economic outlook for many EU countries is negative; (youth) unemployment is at record levels and social discontent is increasing; the political situation in many EU countries remains fragile and uncertain (e.g. in Italy after the end of Mario Monti's technocratic government); and nationalism, anti-EU populism, separatism and political extremism caused – or at least fostered – by the crisis is escalating.

At EU level, the December Summit showed that the danger of complacency is spreading – despite earlier warnings. The EU 27's inability to agree a concrete and binding roadmap/timeline not only for the months but also for the years ahead is worrying. A less ambitious muddling through could not only undermine efforts to strengthen the EU's safety net against the crisis in the framework of the current EU Treaties. It could also threaten more fundamental efforts at a higher level of *sui generis* financial, fiscal, economic and political integration, which would most likely require a more substantial EU reform at some point after the EP elections in mid-2014 and the entry into office of a new Commission and new president of the European Council. In the worst-case scenario, the inability to complete a 'genuine EMU' could once again undermine confidence in the future of the EU and its common currency.

Second, the December Summit demonstrated once again that the Franco-German tandem does not function. The inability of both sides to compromise beyond the lowest common denominator and only at the last possible moment has become a heavy burden for key EU institutions' short- and long-term attempts to move the EU/EMU forward.

The governments in Paris and Berlin are sharply divided on many key issues. Chancellor Merkel wants the EU and its members to stay on the path towards fiscal consolidation, while at the same time exploring new ways how to improve economic coordination to increase the competitiveness of the economically weakest member states. Berlin seems to think that more ambitious steps towards greater fiscal control and economic cooperation – which will also involve a further pooling of competences at EU level – might well require an amendment of the EU Treaties, but only after 2014; i.e. after the German federal and European elections.

President Hollande, on the other hand, wants more fiscal breathing space, a new/big eurozone budget to provide financial assistance to member states in trouble, quick progress towards a banking union that allows direct recapitalisation of banks through the ESM, and, ultimately, a mutualisation of debt. But following the 'traumatic' experience of 2005, for the time being Paris wants to avoid a major treaty change, which could trigger yet another referendum.

These major differences between the current German and French governments and the diverging economic and fiscal situation in both countries are inhibiting progress towards the completion of EMU. The December Summit has clearly shown that the President of the European Council and the European Commission are caught in the middle, and left with the almost impossible task of pleasing both sides at the same time.

Third, on a more positive note, the December Summit has proven once again that it is possible to deepen integration without creating a deep divide between euro and non-euro countries, provided that the EU institutions and the 'ins' (i) keep the door open for 'pre-ins'/'outs' to join new mechanisms/initiatives; (ii) take the interests of countries (still) outside the currency area into account when it comes to concrete issues such as the SSM; (iii) refrain from creating 'insurmountable barriers' that make it difficult for 'pre-ins' to join the common currency in the foreseeable future; and (iv) steer clear of steps which could lead to the creation of a 'two-tier EU' with an involuntary second-class membership.

Non-euro countries have already joined the fiscal compact treaty and the Euro Plus Pact, and they will be able/invited to participate in the new banking supervision system and the new contractual arrangements. The chances are high that many 'pre-ins' will aim to join the common currency once the crisis has been overcome. This is not just in their own interest, but also in the strong interest of those already inside the euro zone.

What to expect in 2013 and thereafter?

For a number of reasons related to some of the challenges mentioned above, one should not expect major breakthroughs in 2013. First, the reduction of the systemic pressures created by the crisis will most likely (continue to) undermine EU governments' readiness to engage in major new initiatives. Instead, most capitals will take a 'let's wait-and-see' attitude.

Second, the current German coalition government will do its best before the elections to contain the crisis and avoid any developments or major new initiatives which might force Berlin to move beyond previously-defined red lines.

Third, the Franco-German relationship is not likely to improve before the German federal elections in September 2013. Before then, neither Paris nor Berlin will be inclined to search for or reach compromises on some of the most divisive, more long-term issues related to the future of the EU/EMU.

However, notwithstanding the improbability of major breakthroughs or major new initiatives, there will still be incremental progress in 2013. At EU level, efforts related to overcoming the eurozone crisis are likely to concentrate on the following:

- implementing new, and partially improving already existing, elements of the enhanced system of economic governance introduced since 2010 ('six pack'; 'two-pack'; TSCG; European Semester; Macroeconomic Imbalance Procedure);
- establishing an effective ECB-based banking supervision system that provides the grounds for a direct bank recapitalisation through the ESM in 2014, although it seems unlikely that the latter will necessarily lead to a (substantial) 'substitution' of 'old loans' provided to Spain, Greece or Ireland to stabilise tumbling banks;
- making further progress towards a banking union by gradually introducing a single banking resolution mechanism (but no single European guarantee scheme!);
- developing the details related to the new contractual arrangements and the new 'solidarity mechanism', and maybe even first concrete steps in this direction.

More far-reaching efforts towards completing EMU are unlikely before the end of 2013. The December Summit has shown that the process towards a more ambitious renewal of the EU/EMU involving all four building blocks – integrated financial, fiscal and economic frameworks, as well as democratic legitimacy and accountability – will not be possible without a rapprochement between Germany and France.

But the chances are high that the political preconditions for reconciliation between Paris and Berlin could be more promising after the German federal elections. It is far too early to predict the outcome of the ballot, but it seems certain that the current conservative/liberal government of the CDU/CSU and the FDP will no longer be in power. Other political parties: the Social Democrats (SPD) and/or the Greens (Bündnis 90/Die Grünen) will either form or join the next German government.

This will increase the prospects of a rapprochement between Berlin and Paris, which is a *sine qua non* for the adoption of an ambitious yet realistic roadmap describing the concrete steps and process towards completing EMU after 2014 – an objective which EU governments already promised in June, but which the EU 27 failed to deliver at the December 2012 Summit.

Janis A. Emmanouilidis is a Senior Policy Analyst and Head of the European Politics and Institutions Programme at the European Policy Centre.