EUROPEAN POLICY CENTRE

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Post-Summit Analysis

# Striking the right balance? An uneventful summit despite mounting socio-political uncertainties

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## Summary

It was not a summit that will enter the EU's history books, and there were no new concrete additional measures to counter low economic growth and high (youth) unemployment. But the 14-15 March European Council did send out a subtle message that EU leaders – concerned about the risks of political and social instability in countries hardest hit by the euro crisis – appear increasingly ready to give struggling EU governments more time to implement fiscal consolidation and structural reforms, provided they remain firmly committed to those objectives. No major breakthroughs or new initiatives to respond to the crisis seem likely this year, but while optimism about the euro's future has increased significantly and everyone is awaiting the results of federal elections in Germany, there is no room for complacency. Policy-makers at EU and national level will have to intensify their efforts to cushion the negative effects of a persistent recession to avoid a potential socio-political explosion in one or other Member State, with incalculable consequences for the entire EU/euro zone, argues Janis A. Emmanouilidis in this analysis of the outcome of the European Council and the challenges that lie ahead.

## Full report

The 14-15 March 2013 European Council meeting was an uneventful summit that will not enter history books.

In line with tradition, the Spring gathering was devoted to Europe's economy, aiming to set orientations for economic policy in 2013. But there were few concrete outcomes, with no specific additional measures to counter low growth and rising (youth) unemployment. The Summit Conclusions merely contain a long list of 'desirables', most of which had already been mentioned in previous European Council conclusions.

There was, however, a subtle message coming out of this meeting: in recognition of the mounting economic and social problems in many Member States and the increasing fear of political instability in some of the countries hit hardest by the crisis, EU leaders seem increasingly ready to give struggling EU governments more time to implement fiscal consolidation and structural reforms, provided that they remain firmly committed to those objectives.

However, the heads of state or government have so far not been able to deliver a convincing and comprehensive European agenda for jobs and growth, especially for those countries suffering most from the crisis. Their main assumption (hope?) seems to be that the economic situation will improve towards the end of 2013 and in 2014 due to increasing demand from outside Europe and the expected positive impact of the return of confidence in the future of the euro.

The European Council took stock of ongoing work on deepening the Economic and Monetary Union (EMU), but EU leaders did not take any concrete decisions on some of the most contentious issues related to the four 'building blocks' of a so-called genuine EMU (GEMU) and will come back to this issue at the June 2013 summit.

After the working dinner for all 27 heads of state or government on Day One of the Summit, European Central Bank President Mario Draghi presented an overview of the economic situation in the euro area at a brief Euro Summit involving only the Euro 17.

Day Two of the Summit was shorter than usual and focused on an informal discussion about the EU's relationship with Russia, but there was no official communiqué on the outcome of that discussion. Another foreign policy issue which was not on the official agenda attracted much more attention: the reiteration of a Franco-British proposal to change the sanctions regime on Syria to allow Paris and London to arm Syrian rebels. No decisions were taken on this, but EU leaders agreed that their foreign ministers would make Syria "point number one on their agenda", as European Council President Herman Van Rompuy put it, at their informal meeting a week after the Summit.

This analysis of the March European Council starts with a short description of the situation ahead of the Summit and then examines the two main topics dealt with at the meeting: the state of Europe's economy and progress towards GEMU. It ends with an assessment of the prospects for the short- to medium-term future.

**The overall atmosphere ahead of the Summit**

In the run-up to this Summit, there had been little change in the overall situation concerning the euro crisis – at least in terms of its financial and fiscal dimensions – since the last ordinary European Council meeting in December, with much greater optimism about the survival of the currency than before summer 2012, when it was in 'deep crisis mode'.

The ECB's decision in September 2012 to provide a 'big bazooka' through its conditionality-based Outright Monetary Transactions (OMT) programme, the substantially reduced risk of a country leaving the euro zone, and the EU's steps towards addressing the incomplete construction of EMU (including the first moves towards the creation of a banking union) have increased confidence in the common currency and reduced the danger of a systemic meltdown. Falling yields on sovereign bonds, rising capital inflows into Europe, an increase in bank deposits in crisis-hit countries (with the exception of Cyprus), a shrinking of the ECB's balance sheet, Lithuania´s application to join the euro in 2015 and an improvement in business and market confidence, all indicate that the danger of a systemic meltdown has decreased significantly.

However, the crisis is by no means over and there is no room for complacency. The situation has improved, but the euro is still not out of the woods. Conditions in the banking sector remain worrying; high private debt levels are causing increasing problems as many households cannot service their loans; and the European banking system remains highly fragmented. Sovereign debt levels are still rising, mostly due to economic contraction, and the systemic consequences of the complex bail-out of Cyprus (including a 'haircut' on bank deposits) agreed at a Euro Group meeting after the Summit, are not clear; the economic forecasts for almost all EU countries are gloomy at least until the end of 2013; and, last but certainly not least, (youth) unemployment has in many European countries reached record double-digit levels.

The social and political consequences of the euro crisis are becoming ever more evident. The public are increasingly dissatisfied with their political elites and are making that dissatisfaction with the 'old establishment' clear in many EU countries. The rise in popularity of Beppe Grillo and his Five Star Movement in Italy, of Golden Dawn and Syriza in Greece, of Marie Le Pen in France, of the True Fins in Finland, of the UK Independence Party, and the thousands of protesters on the streets of Bulgaria, Spain or Portugal signal the increasing discontent with the current state of affairs and are even raising concerns about the state of democracy in many Member States.

Many of these movements/parties employ anti-euro/EU rhetoric to support their cause, but none of them have – at least until now – been able to formulate a credible alternative to EU integration, although some of them claim to have done so. A further worsening of the situation on the ground could give these political forces an additional boost not 'only' at national level, but also at European level, where there is a good chance that more EU-critical or even EU-phobic forces will enter the European Parliament after the 2014 elections.

**The quest for growth-friendly austerity – how to square the circle?**

It was against this general backdrop that EU leaders arrived in Brussels for the Spring European Council. After the traditional meeting with European Parliament President Martin Schulz, the working dinner on Day One of the Summit was devoted to an exchange of views about the state of the EU economy, and the strategy being pursued in national and European economic policies. Following a presentation by European Commission President José Manuel Barroso, EU leaders gave a quick overview of the situation in their home countries and were supposed – at least according to the Summit Conclusions – to "set the orientations for the economic policy of the Member States and the European Union in 2013".

But they did not live up to these ambitions. EU leaders are conscious of the mounting economic and social problems in many Member States and increasingly fear the political instability they could cause, but this did not translate into concrete outcomes at the Summit, with no specific additional measures agreed to fight the growth and unemployment crisis. They seem to be trying to buy time in the hope that growth will return at the end of 2013 and in 2014. In the meantime, however, the "fiscal hawks" appear more willing to grant struggling governments additional time to achieve the necessary fiscal consolidation and structural reforms, provided they remain firmly committed to the objectives.

In the framework of the European Semester, heads of state or government endorsed the five priorities set out in the Commission's Annual Growth Survey for 2013, published last November: (a) pursuing differentiated, growth friendly fiscal consolidation; (b) restoring normal lending to the economy; (c) promoting growth and competitiveness; (d) tackling unemployment and the social consequences of the crisis; and (e) modernising public administrations.

The Summit Conclusions also include a long list of 'desirables', most of which had already been mentioned in previous European Council conclusions. Among them are: (1) shifting taxation away from labour; (2) advancing pending tax files (energy taxation, a common consolidated corporate tax base; revising the Savings Tax Directive; the financial transaction tax); (3) further implementing the Compact for Growth and Jobs, with an assessment due at the next EU Summit in June, focusing on measures aimed at creating jobs and on boosting financing for fast-acting growth measures; (4) promoting employment with a special emphasis on young people (the Youth Employment Initiative; Youth Guarantee; Youth Action Teams); (5) rapid conclusion of the work on all Single Market Act I proposals (including files on accounting, professional qualifications, public procurement, posting of workers and e-identification/e-signature) and adoption of the Single Market Act II proposals before the end of this legislature (May 2014); and (6) efforts at national and European level to cut 'red tape' for businesses (e.g. smart regulation; SME scoreboard; REFIT).

Finally, EU leaders endorsed a proposal from President Van Rompuy to have a number of thematic discussions on specific economic issues to feed into the review of the Europe 2020 strategy scheduled for 2014. Issues to be discussed at upcoming EU Summits include: energy (May 2013); innovation (October 2013); the digital agenda and other services (October 2013); defence (December 2013); and industrial competitiveness and policy (June 2013/February 2014).

In more general terms, and in the words of President Van Rompuy, the EU's overall economic strategy needs to focus on four objectives: (1) to restore and maintain financial stability; (2) to ensure sound public finances; (3) to fight (youth) unemployment urgently; (4) to reform in order to regain long-term growth and competitiveness.

In his joint press conference with President Barroso after the working dinner on Day One, President Van Rompuy emphasised that the EU needs to find a "good balance" and pursue all these strands at the same time. But where should the balance be struck given the current state of the crisis and the overall financial-economic and socio-political situation in Europe and in individual Member States?

Before the Summit, some commentators speculated that EU leaders might be tempted to use the meeting as an opportunity to trigger a fresh debate about "austerity versus growth". This debate has been a constant companion since

the outbreak of the crisis and culminated in recent weeks in a public row between Nobel Prize-winning economist Paul Krugman and European Commissioner Olli Rehn over the 'right' policy approach towards the crisis and public recognition by two leading economists from the International Monetary Fund (IMF) – Olivier Blanchard and Daniel Leigh – that their institution (and others) had misjudged the impact of fiscal consolidation on European economies.

But EU leaders were wise enough not to provoke yet another round of 'ideological' discussions about "austerity versus growth" – a debate that has in the past generally been misguided and over-simplistic. Individual governments and the EU as a whole did – and do not – have the 'luxury' of choosing between the two, and the different elements of European and national responses to the crisis need to be constantly adjusted to find the appropriate balance, taking economic, financial, social and political developments into account and learning from past mistakes.

Those Member States hit hardest by the crisis cannot choose between austerity and growth; they need to do many things at the same time based on a country-specific agenda which takes into account not only individual challenges and weaknesses but also opportunities and strengths. Depending on their situation, they have to find ways to bring their public finances back on track, increase their competitiveness, reform their public sectors, reduce their current account deficits, promote structural reforms in different sectors (pensions, health, tax administration etc.), attract national and international investments, retain or regain access to the financial markets, restore their banking systems so that companies and households have access to liquidity, and – last but not least – explain to their citizens why they deem that the actions they are taking are necessary.

In a nutshell, in their efforts to exit the crisis, governments must constantly seek the right balance: they have to identify ways to reconcile improving their fiscal situation with limiting the negative effects of austerity measures on growth.

Seen from a collective perspective, the EU and its members could not choose between austerity and growth after the euro crisis erupted in 2010. Euro-zone countries would have risked an implosion of the common currency – with incalculable economic and political effects at both national and EU level – if they had not acted to stabilize the situation. They had to embark, collectively and individually, on a path towards fiscal consolidation to regain confidence; they had to find ways to 'help' fellow euro-zone countries and to stabilize the financial system through the creation of bail-out mechanisms (EFSF/ESM); they had to identify ways to begin the process of enhancing EMU governance; and in the end, they had to rely on the ECB's ability to regain and retain the confidence of markets, investors and bank depositors when things began to spin out of control in June/July 2012.

All these crisis responses – which have by no means been perfect – were not a matter of choice or the result of some form of 'altruistic solidarity' between the 'strong' and the 'weak', or *vice versa,* but rather an effort ultimately guided by "enlightened self-interest" (as Italian Premier Mario Monti put it) and an increasing (but yet not strong enough) appreciation of how closely Member States (and especially the countries of the euro zone) had tied their destinies together with the introduction of the common currency ('existential interdependence').

It would therefore be naïve to reduce the debate about the 'right crisis recipe' to a simplistic 'austerity versus growth' contest. It was therefore welcome that EU leaders did not fall into the trap of having yet another round of futile ideological discussions at this Summit.

In reality and mostly driven by the many negative socio-economic and political consequences of the crisis, the EU-17/27 appear to have moved beyond the narrow confines of a rather futile debate. But policy-makers in both weaker and stronger EU countries distrust each other and are still struggling to find ways to adjust their individual crisis recipes and the Union's collective crisis response in the face of manifold challenges.

Although it took too long, EU institutions and governments have since early 2012 increasingly realised that they cannot only concentrate their individual and collective efforts on combatting the immediate financial-fiscal crisis. The pressures

from a deteriorating socio-economic situation and, even more significantly, from electorates and people taking to the streets in many Member States require a stronger focus on the consequences of the growth, social and political crises.

Citizens in the countries most affected by the crisis have either reached, or are close to reaching, the point where they are no longer ready, willing or able to bear its negative collateral effects. A long-lasting recession, rising taxes and cuts in welfare, the rise of (youth) unemployment and a loss of hope have resulted in collective frustration, despair and anger, increasing the risk of an unintended politico-social explosion with unforeseeable consequences in some Member States.

The rise of anti-establishment movements and extremist parties, increasing anti-EU populism and anti-euro sentiments, and the emergence of nationalistic chauvinism and xenophobia have become a serious cause for concern not only in those countries most affected by the crisis but also in others. The elections in Greece in May/June 2012 and the February 2013 polls in Italy – the third biggest economy in the euro zone and a founding member of the EU – have rightly set alarm bells ringing.

This concern has already been reflected in some developments since 2012: the end of public speculation about a possible Greek exit from the euro; the decision to give Spain, Portugal and Greece more time to reach deficit targets; the public discussion about fiscal multipliers (i.e. the effects of austerity on growth) triggered by the IMF; and an increasing emphasis on measures to spark growth and counter (youth) unemployment. All of this indicates that European and national policy-makers – also in better-off countries – are increasingly willing to do more to prevent a politico-social explosion in one or other Member State which could have incalculable negative effects on the entire EU/euro zone. Some of the language used in the March 2013 Summit Conclusions points in the same direction, signalling a somewhat more 'growth-friendly' interpretation of deficit rues: the text refers to the "necessity of differentiated growth-friendly fiscal consolidation" or the inclusion of "short-term targeted measures to boost growth".

But does this mean that fiscal consolidation is off the table? Obviously not. The Summit Conclusions include many references to the need to further reduce public deficits and debts, and continue structural reforms. Heads of state or government from lender countries still underline the need to further reduce public spending. Arriving at the Spring Summit, Finnish Prime Minister Jyrki Katainen said: "There are no shortcuts to creating new jobs and growth in a sustainable manner. Structural reforms might not bear fruit over night, but are the best sustainable economic stimulus. Accumulating excessive debt is not."

At her press conference after the working dinner on Day One of the Summit, German Chancellor Angela Merkel highlighted the need for further fiscal consolidation as an indispensable precondition for growth. One the eve of the European Council, the German federal government announced plans to achieve a balanced budget in 2015, one year earlier than required under the so-called *Schuldenbremse* (debt brake), thus trying to send a signal to other EU governments (especially to France) that growth and fiscal consolidation can go together.

This was interpreted by various commentators as a clear sign that Berlin is ignoring calls for more economic stimulus, even though Germany could 'afford' to spend more to help foster growth in Europe, given its current favourable economic climate (reasonable growth and low unemployment), financial situation (access to 'cheap capital' in the financial markets) and positive fiscal conditions (a low deficit). According to this logic, a 2-3% budget deficit at very low interest rates would help to foster growth, which in the end would also be in Germany's own interests if it helps to counter recession in other EU countries.

There is some truth in this. However, one could also interpret the German government's policy approach differently: i.e. that it is, among other things, trying to send the markets a signal that Europe's biggest economy remains committed and on track, which will in turn give other EU/euro-zone governments more time to get their national budgets in order without creating uncertainty and turbulences in the markets. Following the same line of reasoning, many insist that Germany is already doing its bit to foster demand through higher increases in public and private-sector wages than in recent years.

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But where and when will the desperately-needed growth come from? There seems to be an underlying assumption (hope?) among a vast majority of EU and national policy-makers – supported by forecasts from the Commission, the IMF, the OECD and others – that the economic situation will improve towards the end of 2013 and in 2014 due to a surge of growth and demand from outside Europe (especially China) and the expected positive impact of a return of confidence in the future of the euro.

There is also an assumption that structural reforms in many EU Member States will eventually pay off and stimulate growth and employment, and that in the meantime, ways must be found to cushion the negative effects of reforms. For, as Mario Monti warned: "There is a significant time lag between structural reforms and the results in terms of increased economic activity and job creation." In a letter to President Van Rompuy, he said ways need to be found to "expand the fiscal space available while preserving the credibility of fiscal consolidation". Chancellor Merkel's analysis and prescription sounded similar in a recent speech at the World Economic Forum: "We realise […] that structural reforms and budget consolidation need time to work […] That's something we learned from our own experience in Germany. […] So what's crucial now is to factor in this time-lag, so to speak, and stop the political situation escalating and creating new instabilities."

This second assumption, which seems to be shared by many policy-makers, explains the increasing emphasis on using existing means (reallocation of structural funds; the European Investment Bank's capital increase; Project Bonds etc.) and pushing for the creation of additional instruments aimed at cushioning the negative effects of reforms and austerity, while at the same time maintaining efforts to strengthen the competitiveness of countries struggling to cope with the crisis.

At the December Summit, heads of state or government had already endorsed an idea originally put forward by Germany to introduce limited, temporary, flexible and targeted financial incentives linked to contractual agreements between Member States (involving all euro countries, but also open to non-euro countries on a voluntary basis) and the Commission. As agreed then, details of this new instrument will be presented and discussed at the June Summit, although it is by no means certain that governments will reach an agreement by then as many questions remain unanswered.

In principle, these contracts will aim to promote the implementation of structural reforms in areas where countries are lagging behind by enhancing national ownership and providing specific incentives. They could be used to support reforms aimed at improving non-wage labour costs, unit labour costs, research spending, infrastructure or the efficiency of public administrations. This new instrument will probably contain two key innovations: first, it will include financial support (possibly up to €40 billion) for Member States carrying out country-specific reforms included in national reform programmes; second, national parliaments will be asked to ratify the contracts to ensure reforms agreed at EU level (for example, in the framework of the European Semester) and laid down in national reform programmes will be actually implemented and not end up in the drawers of national administrations, as had happened in the past.

The proposal to introduce contractual agreements linked to financial support is a promising one, but the EU needs to seek additional ways to (swiftly) promote growth and employment in countries suffering most from the crisis.

Obviously, there is no 'silver bullet', but one key to fostering growth and jobs in those countries is for the EU to identify ways to overcome the widespread lack of confidence among potential investors. There are significant European and non-European funds available which are seeking attractive investment opportunities, but political, social and financial risks undermine the readiness to invest in Europe's periphery.

So what could be done to address these barriers? The EU could, for example, create a European Investment Guarantee Scheme (EIGS) to provide a form of insurance for excessive risks incurred when investing in crisis countries. To be credible, such a scheme would require some financial underpinnings, but it would only pay out if the downside risks materialise. The EIGS would resemble a tried-and-tested method of supporting trade and investment: countries such as Germany use similar instruments to provide export credit guarantees for companies dealing with developing economies (for more details, see Fabian Zuleeg, "Squaring the circle – a European Investment Guarantee Scheme", *EPC Commentary*, March 2013).

Giving countries more time to consolidate national budgets, a stronger focus on fighting (youth) unemployment through concrete actions, measures aimed at closing the competitiveness gap between Europe's centre and periphery, the completion of the Single Market, the promotion of investments in crisis-hit countries, and other potential measures – including, for example, a further increase in the EIB's capital, reducing interest rates, recapitalising and cleaning up struggling banks and other steps to overcome financial fragmentation, or allowing higher levels of inflation, at least for a while – all these things, some of which will undoubtedly cost money, point in the right direction, although there are no guarantees that they will be effective and that success will come quickly enough.

**Deepening EMU – no concrete decisions, at least not for the time being**

The Summit did not only concentrate on Europe's economic situation – the Conclusions also mention a number of issues related to a further deepening of EMU. However, EU leaders did not take any concrete decisions on some of the most contentious issues related to the four 'building blocks' of a Genuine Economic and Monetary Union (GEMU) – an integrated financial framework, a fiscal framework, an economic policy framework, and democratic legitimacy and accountability.

EU leaders will come back to this issue at the June Summit, when President Van Rompuy, in close cooperation with President Barroso, is supposed to present possible measures and a time-bound roadmap on four issues: (a) *ex ante* coordination of major national economic policy reforms; (b) the social dimensions of EMU, including social dialogue; (c) the feasibility of mutually-agreed contracts for competitiveness and growth; and (d) "solidarity mechanisms" to enhance the efforts made by Member States which enter into contractual agreements.

Despite the lack of concrete decisions, the Summit Conclusions include some provisions related to the completion of EMU. With respect to a more integrated financial framework, they reiterate the need to restore normal lending, improve competitiveness, resolve outstanding technical issues regarding the new rules for banks' capital requirements (CRD IV), and call on the co-legislators to conclude the legislative process on the Single Supervisory Mechanism (SSM) in the coming weeks.

The Conclusions once again recall that it is "imperative to break the vicious circle between banks and sovereigns". As decided at the EU Summit in December 2012, an operational framework, including the definition of legacy assets, should be agreed as soon as possible in the first semester of 2013. This definition is a key precondition for the direct recapitalisation of banks through the ESM following the establishment of an "effective SSM".

The process toward bank recapitalisation, which will eventually require a unanimous decision of the Euro 17, remains one of the thorniest and most contested issues on the banking union agenda. Nine months on from the June 2012 Euro Summit, when the 17 euro-zone leaders agreed in principle to a direct recapitalisation of banks, governments have still not been able to reach a consensus on how and under what conditions a recapitalisation through the ESM would work in practice. There has even been speculation about whether governments will eventually be able to agree the details of a direct recapitalisation of banks, which could endanger implementation of the instrument.

There is still no agreement on the concrete time-frame or which banks and what kind of assets might be subject to a recapitalisation. It is by no means certain what "effective SSM" will mean in practice and who (the ECB?) will ultimately determine whether and when the system has reached an adequate level of operational capacity. Berlin has repeatedly declared that direct recapitalisation will not be possible before well into 2014. Before becoming Euro Group President, Dutch Finance Minister Jeroen Dijsselbloem even raised doubts about whether the Netherlands will be ready to cede control to the new supervisor by April 2014, when the ECB fully assumes its supervisory tasks within the SSM.

Another issue that needs clarifying is which banks and assets would be eligible for direct recapitalisation. Would this include so-called 'legacy assets', i.e. would the ESM be used to support financial institutions directly even if they got into trouble before the new European supervisory system was put in place? Chancellor Merkel has declared more than once that there would be no "retroactive direct recapitalisation". If this is the case, the Spanish, Irish, Greek and/or Cypriot banks that are already in trouble would not be able to ask for retroactive direct assistance from the ESM.

It is also not clear who would guarantee the funds provided through the ESM to recapitalise banks. Member States might shave to shoulder much of the burden, but this would raise questions about the new instrument's capacity to break the vicious circle between failed banks and their host countries. Governments (and thus ultimately taxpayers) would still have the costs of bank bail-outs on their sovereign books if the country concerned had to guarantee that the ESM would get all its money back.

These are not the only open questions about direct recapitalisation. Another is what proportion of the funds necessary to bail out banks will have to be covered by the host government and how much capital would come from the ESM. In some Member States and in the ESM itself, there are worries that an excessive bank recapitalisation could limit the financial ability of the Stability Mechanism to finance potential future state bail-outs. German Finance Minister Wolfgang Schäuble seems thus to be in favour of limiting the capital available for direct bank recapitalisations to €80 billion. Would a national government have to make a capital contribution or provide a 'loss guarantee' equivalent to a certain percentage of the amount provided by the ESM? Who will determine that a national government is (un-)able to provide the funds necessary to support banks? Who will judge that a failing bank is 'systemic' for the Member State concerned and/or the euro zone in general? All these questions and more will have to be answered before the Euro 17 can reach a final compromise.

On another issue related to the setting up of a banking union, the Summit Conclusions once again call on co-legislators to reach agreement on the Bank Recovery and Resolution Directive and the Deposit Guarantee Scheme Directive before June 2013. Both directives aim to harmonise national legislation. Following strong opposition in numerous Member States – and especially from the German savings banks – original ideas of going beyond mere harmonisation to establish a single European deposit guarantee remain off the agenda (despite recent IMF calls to move in this direction). EU Member States' officials argue that an EU-wide deposit guarantee would not be necessary if there are strong supervisory and bank resolution mechanisms in place. However, it is by no means certain that that the confidence of bank clients in countries hardest hit by the banking crisis will be fully restored without a single European deposit guarantee scheme.

On the establishment of a European resolution mechanism, the Summit Conclusions once again state that the Commission will make a legislative proposal on a Single Resolution Mechanism (SRM) for countries participating in the SSM by summer 2013. The Commission's proposal shall according to plans be adopted during the "current parliamentary cycle", i.e. before May 2014.

However, it is by no means clear whether the EU institutions and governments will be able (and willing) to stick to this ambitious schedule, especially as there is now less immediate pressure from the crisis. It has become already clear that setting up a Single Resolution Mechanism that provides single European rules and means to wind down failing banks, which will ultimately move the power to force losses on bank owners and creditors to the European level, will be (much) more difficult than establishing an ECB-based supervision system. Putting in place and applying an SRM could involve – at least initially – taxpayers' money; money that might in practice be spent on resolving banks in other Member States.

But an ECB-based SSM cannot succeed without a strong European resolution mechanism with sufficient funds available for winding down failing banks. In the absence of a SRM, the ECB would have to rely on national bank resolutions arrangements, which could tie its hands significantly and even undermine the credibility of the entire system.

It is still not clear where the financial means needed for a single resolution mechanism will come from. The European Council Conclusions (once again) merely state that the SRM should be "based on contributions from the financial sector itself" and "include appropriate and effective backstop arrangements". The fact that the Conclusions simply repeat what EU leaders said in December indicates the lack of progress over the last few months. In any case, it will take years to build up a sufficiently equipped resolution fund based solely on contributions from the financial institutions directly participating in the SSM. In the meantime, the ESM could function as a backstop by, for example, providing a credit line to the single resolution authority. However, this cannot be a permanent solution because of the many uncertainties associated with this alternative, which would depend on the consent of EU governments involved in the ESM.

With respect to the fourth GEMU building block – democratic legitimacy and accountability – the Summit Conclusions are once again very weak and vague. EU leaders merely reiterate that any "new steps" towards strengthening

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economic governance will need to be "accompanied by further steps towards stronger legitimacy and accountability". As in the past, it remains unclear what should and could be done to enhance democratic legitimacy and accountability in more concrete terms.

The Summit Conclusions – like those of December and the four Presidents' November 2012 report – do not outline any concrete proposals. There are no indications as to whether some of the proposals that have been put forward and discussed in recent months might point in the right direction. There is no reference, for example, to a potential (increased) role of national parliaments; to a stronger coordination between the latter and the European Parliament (through e.g. a "super COSAC"); to the idea of establishing separate parliamentary formations only including elected representatives from euro countries; to giving Member States more proportional representation in the European Parliament; to making national ministers appear before the Parliament to explain structural reforms underway in their countries; to organising hearings of EU Commissioners in national parliaments; or to having representatives of the new ECB supervisory board appear in front of national and/or the European Parliament.

None of these or other proposals are being put on the table and debated openly in the framework of the current discussions between EU governments and institutions on deepening EMU 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. Second, President Van Rompuy and other key actors (including the presidents of the ECB, the European Commission and the Euro Group) 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 reforming the Union's institutional structure would spur further discussion about whether and how the EU Treaties will have to be amended to implement some of the potential institutional innovations.

Finally, the European Council adopted the rules for organising proceedings at Euro Summits. These rules largely reflect current practice and the provisions already laid down in the Treaty on Stability, Cooperation and Governance (TSCG). The key provisions foresee that: (i) Euro Summits will take place at least twice a year in Brussels, ordinarily after European Councils; (ii) membership of the Euro Summit consists of the heads of state or government of the euro countries, the President of the Euro Summit and the Commission President; (iii) the ECB President and the President of the Euro Group will be invited to participate, and the European Parliament President may be invited to be heard; (iv) the heads of state or government of non-euro countries who have ratified the TSCG will participate in discussions concerning competitiveness, the modification of the global architecture of the euro area and the fundamental rules that will apply to it in the future, and at least once a year in discussions on specific issues of implementation of the TSCG; (v) the Euro Summit President shall be appointed by the heads of state or government of the euro countries by simple majority at the same time as the President of the European Council; (vi) the Euro Summit President will ensure the preparation and continuity of the work of the Euro Summit in close cooperation with the Commission President; (vii) Euro Summits may issue statements prepared under the authority of the President in close cooperation with the Commission President and agreed by consensus.

**What to expect in the months to come?**

Taking into account the lessons of the Spring European Council, it seems worth concluding this analysis with some general predictions about what to expect in the short- to medium-term future. Three potential developments are particularly worth highlighting:

- *No major breakthroughs or major initiatives:* The outcome of the March Summit suggests no major breakthroughs or grand new initiatives linked to the immediate concerns of the financial/fiscal crisis are likely in 2013 due to, first and foremost, the fact that the existential pressures on the euro have been significantly reduced since summer 2012. This positive development has undermined the readiness of EU governments to take swift decisions or put forward new radical proposals, with most capitals likely to continue following a 'let's wait-and-see' approach. However, this does not mean that there will be no progress on issues related to, for example, some of the less contentious questions

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surrounding the creation of a banking union (i.a. SSM, Bank Recovery and Resolution Directive, Deposit Guarantee Scheme Directive) or the introduction of new instruments aimed at enhancing the competitiveness of Member States (improving the European Semester and the Macroeconomic Imbalances Procedure; introducing bilateral contracts). In more concrete terms, the June 2013 EU Summit will probably make progress on the issues put on the agenda in December 2012 (*ex ante* coordination of major national reform; social dimensions of EMU; mutually-agreed contracts; the solidarity mechanism), but final decisions on more sensitive issues such as direct bank recapitalisation or the setting up of a Single Resolution Mechanism will almost certainly not be taken before the end of the year (see also next point).

- *'All eyes on Germany':* The upcoming months will be overshadowed by the wait in Brussels and other capitals for the outcome of German federal elections in September 2013. It is impossible to make firm predictions about the outcome of the elections or their potential consequences for EU affairs six months ahead of the vote. Many outcomes seem possible: in contrast to the picture a couple of months ago, it now seems that the current conservative-liberal coalition of CDU/CSU and FDP led by Angela Merkel might even be able to remain in power, provided the liberals gain enough votes to enter the Bundestag, although polls suggest that a majority of voters would prefer another coalition government led by Chancellor Merkel. Such an alternative coalition could include either the social democrats (SPD) in a grand coalition (the alternative preferred by most Germans) or a coalition between the CDU/CSU and the greens (Bündnis 90/Die Grünen). But if support for Angela Merkel and the CDU/CSU falls in the final run-up to the elections, as happened both in 2004 and 2009, and if the social democrats are able to recover some ground, the SPD will opt for a coalition with the greens led by Peer Steinbrück (SPD). It is even more difficult to make sound predictions about the consequences of the German elections for EU affairs, although some assumptions can be made: a new German government – even if it is not led by Chancellor Merkel – is unlikely to make radical changes when it comes to EU affairs. However, it will be politically easier for a new government with a fresh mandate to take certain 'difficult' decisions concerning, for example, the Single Resolution Mechanism or the direct recapitalization of banks. A government including the SPD and/or the Greens might be more willing to stimulate domestic demand and push forward a substantial, well-targeted but temporary European economic stimulus package (but with no permanent transfers!), although the decision to do so and the overall size of such a package would, obviously, strongly depend on developments in the crisis. With respect to the long-term future of the EU, it is by no means clear whether the next German government will be willing to go beyond the reforms already put on track (banking union; bilateral agreements) or would shy away from innovations that might require another major EU reform exercise (after the Euro-elections in 2014), fearing the consequences of potential failure. Finally, the chances are high that the climate for a *rapprochement* between Paris and Berlin will – independent of the ballot's outcome – be more promising after German federal elections, as both sides will most likely be more ready to compromise.

- *Increasing focus on the socio-political crisis:* It seems likely that EU governments and the ECB will be able to keep the more immediate financial-fiscal dangers resulting from the crisis under control. However, the social and political fall-out, which comes with a certain time lag, is likely to worsen, especially in those countries most affected by the crisis. As a consequence, policy-makers at EU and national level will have to intensify their efforts to cushion the many negative effects of a persistent recession in order to avoid a potential socio-political explosion in one or other Member State, with incalculable negative effects for the respective country and possibly the entire EU/euro zone. The March Summit has shown that EU leaders are increasingly worried about this, but it is not yet clear how far core EU countries will be ready and able to go to try to bridge the time-lag between reforms and an economic upturn. The last three years have shown more than once that readiness to do something ambitious depends on the magnitude of the challenge. But one thing seems certain: next time around, it will be mainly up to governments, individually and collectively, to rise to the challenge – there will be no actor equivalent to the ECB who could act swiftly and decisively enough to avert disaster if things should get out of control.

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