Economic Intelligence

Up-to-the-Minute Analysis from
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'Les yeux plus gros que le ventre?:'[1]
The 27-28 June 2013 European Council

Seldom has a European Council agenda been as loaded as that set for the upcoming meeting of 27-28 June 2013 and seldom has the need for action been as acute.[2] But equally rarely have the prospects for progress been quite as dim.

This uniquely limited scope for success comes not only from political calculations surrounding the upcoming German elections (which will take place on 22 September 2013), but also because any summit decisions – even assuming some boldness on the part of European Union leaders – stand to run into implementation hurdles as the EU institutions enter a prolonged lame duck session. Both the European Parliament elections (on 22-25 May 2014) and the European Commission's renewal (later that year) leave only a narrow window for action in the coming period. The legislative agenda is already hopelessly overcharged, and the forthcoming Lithuanian Presidency of the Council of the European Union is faced with a gargantuan task – even without the addition of new initiatives.[3]

At the same time, there is an evident need for action. The summit takes place six years into the Great Recession. Three of those years have been aggravated in Europe by the specifics of the eurozone crisis. True, markets have been benign of late, thanks mostly to European Central Bank initiatives, but the financial calm is fragile and risks lulling policymakers into

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[1] Having "eyes bigger than your stomach" is a French idiom, usually applied to people who put more food on their plate than they are able to eat.

[2] This Economic Intelligence briefing is the third in a series devoted to pre- and post-European Council analysis. The previous briefings covered the March 2013 European Council. See http://www.lisboncouncil.net//index.php?option=com_downloads&id=799 and http://www.lisboncouncil.net//index.php?option=com_downloads&id=807 on the Lisbon Council website at http://www.lisboncouncil.net and http://www.lisboncouncil.net/chiefeconomist.

[3] For a "gruesome catalogue of all the unfinished business in Brussels" on financial reform alone, see Alex Barker, "EU Finance Reforms: The Great Lithuanian Reckoning," *Financial Times*, 12 June 2013. http://blogs.ft.com/brusselsblog/2013/06/eu-finance-reforms-the-great-lithuanian-reckoning/

complacency.[4] The fragility of the calm is evidenced by the disconnect between financial markets and the real economy. Already, the European Commission and other leading institutions have been forced to revise even their already dismal growth forecasts downward – and G8 leaders acknowledged at their recent Lough Erne summit that prospects for growth in some parts of the global economy (and notably the euro area) are weaker than they were when the leaders last met in May 2012.[5] In addition, jitters risk rising in the face of global market turbulence, renewed political instability in Greece, questions over Cypriot commitment to the agreed bailout programme and concerns about the potential for social unrest stirred by high unemployment in many countries.[6]

It is against this backdrop that Herman Van Rompuy, president of the European Council, sent European leaders a letter in late May, pleading the case for "work at the June European Council to the benefit of an entire generation of young Europeans."[7] The effort is supposed to include a renewed push to improve funding to small- and medium-sized enterprises. While the initiative is welcome – given the shockingly high unemployment levels (especially among the young) and the dearth of bank, seed and venture-capital funding for small-businesses and start-ups in Europe – some argue that the decision to focus solely on youth unemployment risks masking the deeper causes of that unemployment and others say meaningful initiatives in this area are probably unlikely.[8] The more cynical maintain the new "priorities" are simply a rhetorical smokescreen to appease popular pressures at home and cover the probable lack of progress on other key issues on the European Council's plate.

And that plate is indeed piled high, due in no small part to postponements of other decisions over time and to slippages even relative to such deferrals. The European Councils in June, October and December of 2012 all delegated tasks to the June 2013 meeting, stipulating that it examine:[9]

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[4] Alessandro Leipold, "Lessons from Three Years of Euro-Area Crisis Fighting: Getting It Right Next Time," *Lisbon Council Special Briefing 14/2013* (Brussels: Lisbon Council, 2013). http://www.lisboncouncil.net//index.php?option=com_downloads&id=857

[5] In May, the European Commission revised its 2013 forecasts downward, predicting -0.1% growth in the EU and -0.4% in the eurozone. The recovery, under this scenario, would come in 2014, making 2013 the fourth consecutive year in which a predicted economic recovery was pushed back by 12 months. See European Commission, *Spring 2013 Forecast: The EU Economy – Slowly Recovering from a Protracted Recession* (Brussels: European Commission, 2013). http://ec.europa.eu/economy_finance/eu/forecasts/2013_spring/overvieuw_en.pdf

[6] In April, 26.5 million people were unemployed in the EU, a rate of 11%; 5.6 million of those people were under the age of 25, giving an overall 23.5% unemployment rate among the young. In Greece, Spain and Portugal, the youth unemployment rate spikes to a staggeringly high 62.5%, 56.4% and 42.5%, respectively. In Italy, it is 40.5%. See Eurostat, *Euroindicators News Release 82/2013 – 31 May 2013*. http://bit.ly/15nYedw

[7] Letter by President Herman Van Rompuy to the members of the European Council on Youth Employment, Brussels, 24 May 2013. http://europa.eu/rapid/press-release_PRES-13-215_en.pdf

[8] For a questioning of the relevance of youth unemployment as a policy target, see Daniel Gros, "Europe's Youth Unemployment Non-Problem," *Project Syndicate*, 06 June 2013. http://bit.ly/1a3KNEx

[9] What follows is drawn from the three 2012 European Council Conclusions, or the related eurogroup summit meetings, available respectively at www.european-council.europa.eu/council-meetings/conclusions and www.eurozone.europa.eu/documents/.

- **Coordination of national reforms**, with participating member states invited to ensure that the major economic policy reforms they plan to undertake will be discussed ex ante and, where appropriate, coordinated among themselves;

- The feasibility and modalities of mutually agreed **Contracts for Competitiveness and Growth**, understood as individual arrangements of a contractual nature with EU institutions, differentiated depending on member states' specific situations;

- **Solidarity mechanisms** and measures to promote the deepening of the single market and protect its integrity, intended to enhance the efforts made by member states that enter into the above contractual arrangements;

- Proposals for a **Bank Recovery and Resolution Directive** and a **Deposit Guarantee Scheme Directive**: agreement on these was to be achieved by March 2013, but has slipped and remains elusive, as evidenced by the debacle over the former at the Economic and Financial Affairs Council of 21 June 2013;

- **Operational framework for the European Stability Mechanism** granting the ESM the possibility of recapitalising banks directly once an effective single supervisory mechanism is established (this too was to have been decided as soon as possible in the first semester of 2013, but likewise slipped, with agreement now reached at the eurogroup meeting of 20 June 2013);

- **Social dimension of European Monetary Union**, including social dialogue.

In addition, the June European Council has an institutional role within the **European Semester**: it should conclude the exercise by formally endorsing the country-specific recommendations issued by the European Commission at end-May and approved by the last Economic and Financial Affairs Council.[10] Finally, as if that weren't enough for a two-day meeting that only begins on Thursday afternoon, European leaders are slated to discuss **Latvia's application to adopt the euro** as from 01 January 2014.[11]

What comes first?

As can be readily seen, even without the addition of youth unemployment, the catalogue of items for consideration is unwieldy, and in dire need of prioritisation. In doing so, the European Council would do well to order the items as follows:

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10 For the initial country-specific recommendations, see European Commission, *Moving Beyond the Crisis: Country Specific Recommendations 2013* (Brussels: European Commission, 2013) www.europa.eu/rapid/press-release_IP-13-463_en.htm; for the versions actually approved by the Council of the European Union, see Council of the European Union, *Country-Specific Recommendations on Economic and Fiscal Policies* (Luxembourg: Council of the European Union, 2013). http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/137558.pdf

11 European Council Annotated Draft Agenda, 13 May 2013. http://register.consilium.europa.eu/pdf/en/13/st09/st09165.en13.pdf

- **Strengthening and stabilising the European banking system** (notably the operational framework for direct ESM bank recapitalisations and the banking directives). These items are core crisis resolution issues on which progress is of the essence. This is true not only because of the longer-term goal of banking union but, more immediately, because addressing banking problems is key to rekindling growth. Possibly the main reason the United States is growing and Europe is not is that the former has done a far better job of cleaning up its banks, while Europe remains saddled with "zombie" institutions unable to provide credit to finance growth – much as in Japan during its prolonged stagnation. Indeed, the single most important contribution EU leaders could now make to bolster European growth (and cut youth employment itself) is to create the conditions for a revival of bank lending, countering the fragmentation of euro area financial markets and breaking the bank-sovereign doom loop.

  Compromises on these divisive issues risk falling short of these objectives, as evidenced by the timid positions taken in the joint Franco-German Declaration issued in May, in advance of the summit.[12] The divisions came to a head at the meeting of the Economic and Financial Affairs Council of 21 June, which failed to agree on the "bail-in" rules to be used when banks are recapitalised with public money.[13] But the preceding eurogroup meeting of 20 June did reach important agreements on direct bank recapitalisations by the ESM.[14] While the agreed framework only "dilutes," rather than "breaks," the bank-sovereign link, with member states still required to share the burden adequately, there were a number of positive openings. First, the rules on member states' contribution to the financing could be suspended in "exceptional cases." Second, the door was not completely shut on the possibility of "retroactive" application of the instrument – relevant for Ireland and Spain, which were granted support before the ESM had the power to recapitalise banks directly. Such retroactivity will be dealt with on "a case-by-case" basis – a true-and-tried approach used by the IMF to allow judgmental flexibility across a broad range of policies. Third, while the total amount of ESM resources that can be used for bank recapitalisations was, as expected, capped at €60 billion, the ESM's board of governors was given the power to raise that limit.

  Against this background, the June 2013 European Council should confirm and ideally expand the operational flexibility of the ESM's bank recapitalisation instrument, allowing room for manoeuvre with regard to member states' contributions, the possibility of retroactive application and the ceiling on resources. Its entry into operation (unlikely, on present plans, before the second half of 2014) should be speeded up as much as possible, along with the related Single Supervisory Mechanism. At the

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[12] "France and Germany – Together for a Stronger Europe of Stability and Growth," 29 May 2013. http://bit.ly/12iHccD

[13] Peter Spiegel, "EU Fails to Agree on Bank Bailout Rules," *Financial Times*, 22 June 2013; http://www.ft.com/intl/cms/s/0/8bbfdf84-daeb-11e2-a237-00144feab7de.html#axzz2We870jLL, and James Kanter, "Unable to Reach Deal, Europe Plans New Talks on Bank Rescues," *The New York Times*, 21 June 2013. http://nyti.ms/144C1kW

[14] Eurogroup, "ESM Direct Bank Recapitalisation Instrument: Main Features of the Operational Framework and Way Forward," Luxembourg, 20 June 2013. http://www.eurozone.europa.eu/media/436873/20130621-ESM-direct-recaps-main-features.pdf

same time, progress on the Bank Recovery and Resolution Directive is obviously also essential, given the role it has been assigned in determining the degree of "bail-in" before a bank is recapitalised by the ESM. The debate over the appropriate degree of flexibility of rules in this area, which divided the last Economic and Financial Affairs Council, is a long-standing one in the history of banking resolution and safety nets, with a rich literature on the pros and cons of "constructive ambiguity" on the matter.[15] That resolution of such a central issue has been left to a last-minute special meeting of the Economic and Financial Affairs Council is a somewhat inauspicious curtain-raiser to the summit itself.

- **Youth unemployment and revival of SME lending**: Because of the disheartening reality on the ground and the expectations raised by the prominence assigned to these items, the absence of concrete European Council action would be a renewed blow to confidence and credibility. That said, *realpolitik* suggests that actionable levers are few and likely not very effective – after all, the Compact for Growth and Jobs is celebrating its first anniversary with scant results.[16] In addition, just over the past six months, a "Youth Employment Package" was launched in December 2012; a "Youth Employment Initiative" was proposed by the Council of Ministers of the European Union in February 2013; a "Youth Guarantee Recommendation" was adopted by the Council of Ministers of the European Union in April 2013; and a consultation with social partners is under way on a "Quality Framework for Traineeships," alongside a "European Alliance for Apprenticeships." In the meantime, however, the €6 billion envisaged in the 2014-20 EU budget to support some of these initiatives is blocked by wrangling with the European Parliament. The European Council would be a success on the employment front if it simply managed to carry forward and fully fund the initiatives already decided – ideally via some front-loading – rather than diffusing the effort with yet another grandiose (but unfunded) announcement whose implementation prospects would remain typically bleak.

- The European Council will of course proceed with the one, relatively uncontroversial, item of formally **endorsing the country-specific recommendations as part of the European Semester**. But this should not, as it has on the two previous occasions, be a mere formality, expressed with a joint and blanket endorsement of the Commission's recommendations by the 27 EU leaders, buried in the text of European Council Conclusions, in much too vague and general a manner to have any impact domestically.[17] This is clearly no way to communicate, and it is a far cry from the transparent and inclusive communication strategy advocated by the Europe 2020

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15 For seminal texts on two sides of this issue, see Charles P. Kindleberger, *Manias, Panics, and Crashes: A History of Financial Crises* (New York: Wiley, 1978), and Stanley Fischer, "On the Need for an International Lender of Last Resort," *Journal of Economic Perspectives*, Vol. 13, Fall 1999.

16 As indeed recognized in the Commission's report to the June European Council: implementation "delays mean that business opportunities are lost and that much needed jobs are not created." See European Commission, "The Compact for Growth and Jobs: One Year On." http://ec.europa.eu/commission_2010-2014/president/news/archives/2013/06/pdf/2_en.pdf

17 The conclusions of last June's European Council simply read "the European Council generally endorsed the country-specific recommendations…" The fact that to be apprised of the actual recommendations one has to refer back to the conclusions of the preceding Ecofin, along with the qualifying adverb ("generally" endorsed), do not make for clarity.

Integrated Guidelines, aimed at enhancing the impact on national policymaking. To begin to do so, the European Council Conclusions should be clear and self-contained, specifying, for each country, the three to four actionable reforms that are identified for the coming year, listing them in individual country paragraphs, and with the individual heads of state and government thus subscribing to them in a much more specific (and accountable) manner. In setting these, and in keeping with the arguments above, priority could usefully be assigned to country-specific recommendations addressing the banking sector and the labour market-employment nexus.

Dessert and coffee?

Much has been pinned on this June 2013 European Council. An outcome that is, and is viewed as, successful is key to progressing further on the exit from this long crisis. To this end, the European Council will need not only to advance on (and fund) the range of employment initiatives, but also – and indeed above all – achieve real progress in addressing banking problems. It needs (after the many declarations) to move rapidly toward breaking the lethal link between ailing banks and indebted sovereigns and to reverse the disintegration of eurozone financial markets, creating the conditions for lending to resume throughout the area. Without a revival of bank lending, economic prospects will remain grim. In such a setting, insufficiently funded EU initiatives in favour of SME lending or youth employment – while helpful in their own right – will have only marginal effects. Growth is the key to employment, and bank lending is the key to growth – therein lies the June European Council's Gordian knot.

This summit is also the last before the summer – a notoriously crisis-prone period. Mario Draghi's "whatever-it-takes" carried the euro area unscathed through the summer of 2012 and even beyond. As the ECB president never tires to observe, it is however now time for politics to deliver. As a political body par excellence, it is up to the European Council to do so. We will assess how well it has delivered on the identified priorities in a subsequent Economic Intelligence briefing, to be issued shortly after the European Council's conclusion.

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