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Up-to-the-Minute Analysis from
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The 14-15 March 2013 European Council: Post-Summit Analysis

Was the European Council of 14-15 March really a non-event, as portrayed in much of the press coverage – or lack thereof, with unusually low attendance at the closing press conference?[1] Certainly, there were no attention-grabbing clashes, surprisingly little self-interested posturing, no polemical confrontations. By all accounts, it was rather a collaborative and attentive European Council, ready to listen to detailed presentations from European Commission President José Manuel Barroso and European Central Bank President Mario Draghi on competitiveness and the foundations for growth (a total of 34 slides in all, about evenly split, at a rather late hour).[2]

This change of tone and attention to underlying issues is in itself newsworthy. It may be the first palpable result of the vote in Italy and discontent elsewhere, with European Union leaders seemingly taking note. It may also have something to do with personalities: Jeroen Dijsselbloem, for example, avoided postings to his twitter account throughout the proceedings (a far cry from the sometimes acerbic running commentary provided in the past by his predecessor, Jean-Claude Juncker, the outgoing chairman of eurogroup.). Whatever the cause, the changed mood allowed the European Council to deliver, admittedly in muted tones but not insignificantly. Specifically, this European Council provided:

- a shift of gears in the approach to budget consolidation and growth;

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[1] For a flavour of the coverage, see for example "EU Leaders Avoid Clashes at Lacklustre Summit on Growth," *EurActiv*, 15/03/2013 http://bit.ly/XQP73F

[2] For President Barroso's presentation, see "Growth, Competitiveness and Jobs: Priorities for the European Semester 2013" http://bit.ly/15QQG3m . For President Draghi's presentation, see "Euro Area Economic Situation and the Foundations for Growth" http://bit.ly/XQO4Ro.
On the EU rebalancing process more generally, see also *The Euro Plus Monitor Spring 2013 Update*, published by the Lisbon Council and Berenberg Bank on the eve of the European Council meeting http://www.lisboncouncil.net//index.php?option=com_downloads&id=787.

- a narrower focus on priority structural reforms; and
- an affirmation of the commitment – which had sometimes appeared in doubt – to break the vicious circle of sovereign and bank debt via direct recapitalisations of banks by the European Stability Mechanism (ESM).

A Shift in Tone on Budget Consolidation and Growth

Communiqués are the battlefield on which contemporary European politics are fought. And the 14-15 March European Council was notable not so much for the fieriness of the engagement, as for the marked lack of bodies falling on what would normally have been a very bloody field. In the run-up to this European Council, some feared a showdown over the "growth versus austerity" debate, prompted *inter alia* by the results of the Italian election, protests in Portugal and elsewhere, pressures from France and the almost daily bromides of influential economists such as Paul Krugman. The face-off was avoided, in part, by the measured tone of a letter – dispatched on the eve of the summit – from Prime Minister Mario Monti to European Council President Herman Van Rompuy, in which Prime Minister Monti made a well-argued (albeit arguably belated) case for "controlled flexibility" in the adjustment expected from reforming countries.[3] Helpful clarifications were also provided by the publication, just ahead of the European Council, of two well-timed research notes from the European Commission's Directorate-General for Economic and Financial Affairs.[4]

Good music like this ultimately made for a notable shift in tone, illustrated by the following three passages from the European Council conclusions (emphases added):[5]

- "The European Council stresses in particular the necessity of *differentiated growth-friendly fiscal consolidation*;"
- "There should be an appropriate mix of expenditure and revenue measures… including *short-term targeted measures to boost growth and support job creation… and prioritising growth-friendly investment*;"
- "The possibilities offered by the EU's existing fiscal framework to *balance productive investment needs with fiscal discipline objectives* can be exploited in the preventive arm of the stability and growth pact."

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[3] Prime Minister Monti's letter is available at http://bit.ly/XQPuv2.
[4] Marco Buti and Nicolas Carnot, "The Debate on Fiscal Policy in Europe: Beyond the Austerity Myth," *ECFIN Economic Brief*, Issue 20, March 2013 http://ec.europa.eu/economy_finance/publications/economic_briefs/2013/pdf/eb20_en.pdf, and Gilles Mourre, George-Marian Isbasoiu, Dario Paternoster and Matteo Salto, "The Cyclically-Adjusted Budget Balance used in the EU Fiscal Framework: An Update," in *European Economy-Economic Papers*, No. 478, March 2013 http://ec.europa.eu/economy_finance/publications/economic_paper/2013/pdf/ecp478_en.pdf.
[5] Council of the European Union, *Conclusions of the European Council*, 14 March 2013, EUCO 23/13 http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/136151.pdf.

To be sure, the objective of "pursuing differentiated growth-friendly fiscal consolidation" was already one of the five priorities (indeed the first one) of the 2013 Annual Growth Survey, endorsed by the Economic and Financial Affairs Council of 12 February 2013.[6] And this European Council was careful to recall that everything it said on these points was consistent with "the possibilities offered by the existing fiscal framework." What's more, the explicit reference to the "preventive arm" of the stability and growth pact as the stage at which a balance between investment and fiscal discipline should be sought excludes recourse to such trade-offs as part of the "corrective arm" (i.e., the mechanism that is invoked when the 3% of GDP deficit limit has been breached) – which is of course the current bone of contention.

But the fact that words like these were included in the conclusions at all and survived (almost verbatim) from the pre-summit draft, is significant – and should not be taken for granted. It denotes sensitivity, even if overdue, to these issues. The passages above are now at the core of the strategic guidance that this European Council was called on to provide for member states' national budgetary policies – no doubt, they will be recalled and invoked by interested countries as the rest of the European Semester unfolds, and beyond.

Flexibility for Portugal and Ireland

Far more critical than communiqués, however, is action on the ground. And in this regard, the extra leeway granted to Portugal on 15 March is noteworthy and welcome. On the concluding day of the summit, the EC-IMF-ECB "troika" issued a statement recognising that Portugal's "weaker growth prospects require an adjustment of the fiscal deficit path" and a revision of the deficit targets "to allow the operation of automatic fiscal stabilizers."[7] This is precisely the emphasis on structural (i.e., cyclically-adjusted) deficits that is required, as advocated in our pre-summit Economic Intelligence briefing.[8]

In practice, however, the public rhetoric surrounding the appropriate pace of fiscal adjustment continues to be confusing, and the primacy of structural fiscal targets struggles to establish itself clearly. Thus, for example, shortly before the summit, Bundesbank President Jens Weidmann was quoted as stating: "One can always discuss the details – structural consolidation versus nominal targets – but at the end of the day, nominal targets are a lot more visible."[9] They undoubtedly are, and the difficulty of formulating and

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[6] Council of the European Union, *Council Conclusions on the Annual Growth Survey 2013*, 12 Feb. 2013 http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/135432.pdf. See also European Commission, "Annual Growth Survey 2013," *Communication from the Commission* (Brussels, 28/11/2012, COM(2012) 750 final) http://ec.europa.eu/europe2020/pdf/ags2013_en.pdf.

[7] The deficit targets were raised to 5.5%, up from 4.5%, of gross domestic product in 2013, and to 4%, up from 2.5%, in 2014. International Monetary Fund, Statement by the EC, ECB, and IMF on the Seventh Review Mission to Portugal, *Press Release No.13/78* (Washington DC, 15/03/2013) http://www.imf.org/external/np/sec/pr/2013/pr1378.htm.

[8] See Alessandro Leipold, "The European Council of 14-15 March 2013: Can It Deliver?" *Lisbon Council Economic Intelligence*, 01/2013 http://www.lisboncouncil.net/index.php?option=com_downloads&id=799.

[9] Hugh Carnegy, Michael Steen and Quentin Peel, "Bundesbank Warns Paris on Deficit Target," *Financial Times*, 12 March 2013 http://on.ft.com/XgiCIC.

monitoring structural targets is not to be underestimated. But adherence to nominal objectives when growth deviates from assumptions exacerbates cyclical swings – in upswings as much as downswings. It is what caused pro-cyclical fiscal stimulus during, for example, Spain's real estate boom. Nominal targets were fully respected (as they were in Ireland) but the fiscal stance was unduly expansionary. The failure to build up adequate buffers in terms of fiscal surpluses during "good times" restricted the scope for countering the subsequent slowdown. As long as the emphasis in European policy guidelines does not shift clearly to structural targets – not only *de jure* (as is already partly the case) but crucially also *de facto* – such harmful pro-cyclicality will continue to mar the EU's approach to fiscal consolidation.[10]

Fortunately, flexibility was indeed shown by the eurogroup's decision on 16 March (shortly after the European Council's conclusion) to extend the maturities of European Financial Stability Facility loans to Ireland and Portugal, helping smooth their debt redemption profiles (as advocated in our pre-summit briefing). The imperative of securing some "success stories" in this long crisis transpires from the eurogroup ministers' stated determination "to support Ireland's and Portugal's efforts to regain full market access and successfully exit their well-performing programmes."[11]

Narrowing Structural Reform Priorities

The European Council was also scheduled to provide guidance for countries' structural reforms, as contained in their National Reform Programmes. Here it helpfully narrowed down often overly-broad indications – where everything (and thus nothing) was a priority -- to three main areas: employment (particularly youth employment), the single market, and "smart regulation."

For this guidance to have any effect, however, the country-specific recommendations to be prepared by the European Commission will need to be equally focused. In endorsing them as planned at the 27-28 June European Council, the conclusions will also need to be clear and self-contained, specifying for each country the 3-4 actionable reforms identified for the coming year, listing them in individual country paragraphs, and with the individual heads of state or government subscribing to them in a much more specific (and accountable) manner than has been the case hitherto. In the first two European Semesters (in 2011 and 2012) the European Council simply conferred an overall blanket endorsement to the

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[10] As noted in Buti et al (op. cit.), under the stability and growth pact, an excessive deficit procedure is not to be triggered if the "structural effort" (specified in terms of changes in the cyclically-adjusted balance net of one-off and temporary measures) has been delivered. But the public discourse, and related peer pressure, tends to be largely framed in terms of nominal targets.
[11] Eurogroup Statement on Portugal and Ireland, 16 March 2013 http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/136194.pdf. The same eurogroup meeting also agreed on measures regarding the truly thorny case of Cyprus, with ramifications going beyond the scope of this briefing; see Eurogroup Statement on Cyprus, 16 March 2013 http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/136190.pdf.

European Commission's recommendations, in too vague and general a manner to have any impact domestically.

Direct Bank Recapitalisations

In our pre-summit briefing, we also noted the importance of progressing on other crisis resolution tools, among which the need to end the ambiguity surrounding direct bank recapitalisations by the ESM. Here the European Council recalled its June 2012 "imperative" of breaking the vicious circle among banks and sovereigns. After some recent rhetorical backtracking, this reconfirmation is welcome, tying the European Council's hands going forward. The European Council also reaffirmed its timeline, pressing that an operational framework, including the definition of legacy assets, be agreed as soon as possible in the first semester of 2013. But it reiterated that direct ESM recapitalisations will be possible only "when an effective single supervisory mechanism is established" – without defining either "effective" or "when." On 15 March, as the European Council was ending, the IMF published its first-ever Financial Stability Assessment for the European Union, with a detailed analysis of how much remains to be done to restore financial stability in Europe – it is indeed a formidable agenda.[12]

Quo Vadis Europa?

All in all, it was a positive summit, with European leaders evincing a new willingness to work together on matters of grave economic import, and even ready to sit and listen in an open spirit while the European Commission and European Central Bank held forth (privately) on productivity, quality of public finances, and policy approaches that might help lift prosperity in the countries the leaders know best. But, to be sure, the economic news continues to be grim and the challenges remain formidable. Only three weeks ago, the European Commission revised its annual growth projections downward, forecasting that eurozone recovery – once predicted for 2013 – would once again be postponed by 12 months (the third year in a row that this phantom recovery has been pushed back).[13] In this setting, the employment situation remains dire, with unemployment running at a post-war record of 11.9%, with a staggering 26.2 million Europeans (5.7 million of them under the age of 25) seeking work. And the Commission predicts the figure is likely to go up – perhaps as high as 12.2% later this year in the euro area – before it starts improving (along with the overall economy) in 2014. This latter prediction, too, hangs in the balance.

[12] See International Monetary Fund, *European Union: Financial System Stability Assessment* (Washington DC: IMF, 2013) http://www.imf.org/external/pubs/ft/scr/2013/cr1375.pdf.
[13] European Commission, *European Economic Forecast* (Brussels: European Union, 2013). http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee1_en.pdf

All of this does not detract from the fact that reforms can and do work – but, as recognized by Chancellor Angela Merkel in her press conference, their effects take time. It is important that Europe offer reforming countries enough time for the difficult measures undertaken to bear fruit, and provide Member States with – in the words of Prime Minister Monti – "the room to accompany a credible fiscal consolidation programme with targeted actions to support the economy." And, while the leaders stopped short of sending a "business-as-usual" message – preferring to show that they are aware of the debates raging in Europe and the difficulties which the needed budgetary consolidation has brought – they were able to avoid the unhelpful ideological battles of yore and project an image of unity, realism and political maturity. It is a hopeful sign that – after years of institution-building to fight the crisis – European leaders may be ready to take the crucial next steps: supporting concrete national measures to raise competitiveness, increase growth and drive sustainable job creation in Europe. The 27-28 June European Council will show how much of that realism was just a useful fillip after a tumultuous few years – and how much of it is here to stay.

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