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European Newsletter

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Note from the editor

This newsletter monitors and analyses institutional and political developments in the European Union, with a particular interest in any developments relevant to the future of the European Constitutional Treaty. It will regularly feature contributions from expert commentators on current European issues, providing a platform for differing opinions. Views expressed are those of the authors and are not necessarily shared by the Federal Trust. Back issues are available at http://www.fedtrust.co.uk/european_newsletter.

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1. Editorial: Mr. Brown comes to Brussels

On present plans, the German Presidency in the first half of next year will conclude its work with a European Council at which a procedure and timetable will be adopted for the relaunching of the process to revise the institutional workings of the European Union, a process which came to an abrupt halt with the "no" votes in the French and Dutch referendums last year. This European Council may well be the first such meeting which Gordon Brown will attend as British Prime Minister. It is not too early to start wondering about the changes, if any, that Mr. Brown will make as Prime Minister to Britain's European policy, and in particular what his view will be of the future path of institutional reform the Union should follow.

It is a commonplace to say that much remains uncertain about Mr. Brown's future policies as Prime Minister. Journalists and commentators rightly point out that he has been circumspect over recent years in the comments or commitments he has made that might be held to limit his room for manoeuvre as Prime Minister. As far as the European Union is concerned, however, he is not exactly an unknown quantity. He has played a major role in shaping the Labour government's European policy over the past decade.

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...is a think tank that studies the interactions between regional, national, European and global levels of government.

Founded in 1945 on the initiative of Sir William Beveridge, it has long made a powerful contribution to the study of federalism and federal systems.

Although when the Labour Party was in opposition in the early 1990's, Mr. Brown gave to many observers the impression that he was well-disposed to British membership of the European single currency, any enthusiasm he may have felt for that membership rapidly disappeared during his time in office. Over the past decade, Mr. Blair has on a number of occasions attempted to mobilise debate and opinion in favour of British entry into the euro, but Mr. Brown has always been the rock on which even the beginnings of this debate foundered. Indeed, Mr. Brown has been prominent in his criticism of what he generally regards as poor economic management in continental Europe. Where Mr. Blair has struck a more conciliatory line on such questions as the European budget, Mr. Brown and his advisers have consistently ingratiated themselves with the influential Eurosceptic press in the United Kingdom by polemical and provocative briefings to present Mr. Brown as protecting the United Kingdom against the economic and political damage supposedly arising from an uncritical enthusiasm for all things European. British voters have always seen the argument for Britain's membership of the European Union as primarily an economic one. Mr. Brown has used his undeniable authority as a relatively successful Chancellor of the Exchequer over the past decade regularly to cast implicit doubt upon that argument.

It may well be that as Prime Minister, Mr. Brown will find it prudent and appropriate to adopt a less dismissive and confrontational tone towards his fellow heads of state and government than he has towards his fellow European finance ministers. He is aware that his sometimes surly image in the past has counted against him for many British voters when compared with the superficially more affable Mr. Blair. But in addition to his clear personal reservations about recent developments in the European Union (his few public comments on the European Constitutional Treaty were tepid at best), Mr. Brown's approach at next year's European Council to any question of relaunching the Constitutional Treaty will be conditioned by another important factor, the British electoral timetable.

British electoral questions have always been of understandable concern to New Labour in the establishment of its European policy. Mr. Blair and Mr. Brown have worked effectively to detach from the Conservative Party that part of its electoral base which was concerned about the obsessive Euroscepticism of the Party. Moreover, the European issue was one with clear potential to divide the Conservative Party more than it did Labour. At the same time, New Labour has been careful not to offend its actual or potential voting supporters who would have been uneasy at too obviously pro-European a stance. Mr. Brown seems likely to have some such electoral template in mind as Prime Minister. If the Conservative Party can be portrayed as extremist and irresponsible in its European policy, New Labour will happily attack it. If the Conservative Party moderates its tone on Europe, New Labour will see little electoral advantage in parading its pro-European credentials too vigorously.

The next General Election in the United Kingdom will probably take place in 2009 or 2010. All Mr. Brown's energies as Prime Minister will be directed towards a victory at that time. It would be remarkable if he overlooked the potential harm that, for instance, a revived European Constitutional Treaty could do his electoral chances over the next two or three years. In particular, any referendum on a revised Treaty in the United Kingdom before the next General Election would be a path fraught with peril for the new Prime Minister.

Mr.Brown knows that any document bearing any substantial similarity to the Constitutional Treaty rejected by the French and Dutch electorates will need to be submitted to a referendum in this country before it can be ratified. He will also know that his chances of winning such a referendum are very poor, especially if the Treaty has been modified in such a way as to make it more acceptable to the French and Dutch electorates. Not only would these changes probably make the text even less palatable to British voters, but they would be powerful incentive for British electors to reject the Treaty in order to achieve their own preferred changes in the way that their French and Dutch neighbours had. It would be the worst possible preparation for a potentially difficult General Election for Mr. Brown to have fought and probably lost a referendum on a revised European Constitutional Treaty. He can be expected to do everything possible to prevent that from happening.

In his likely apprehension towards any proposals for a revived Constitutional Treaty, Mr. Brown will probably not be alone at the European Council. Many countries which postponed their referendums on the original Treaty, such as Poland, the Czech Republic and Denmark, might well have difficulties in ratifying any revised Treaty as well. If, as is conceivable, Mr. Brown shows himself to be an advocate at next year's European Council of amending the existing European Treaties through a limited number of discrete and largely consensual textual changes, he might well find support for such an approach. Arguably, he would in this be following the logic of Mr. Sarkozy's recent proposal for a "mini-treaty," but paring down yet further its provisions. A "mini-mini" treaty which, for instance, allowed for some more majority voting in the Council, reweighted votes in the Council, improved co-ordination in European foreign policy, involved national parliaments more in the European legislative process, established a semi-permanent Presidency for the Council and gave legal effect in European legislation to the Charter of Fundamental Rights would not need a referendum in the United Kingdom and might not need a referendum in France either. Elements could of course be added to or subtracted from this package, but those favouring this course of action would presumably wish to avoid the wholesale "horse-trading" which underlay the rejected Constitutional Treaty and made it so inaccessible to the European electorate.

The British government has been noticeably reticent about its view of the way forward for the European Constitutional Treaty after the French and Dutch referendums. Its reticence has at least partly been a function of its recognition that it would be almost impossible to win a British referendum on the Treaty after the French and Dutch rejections. Until now, it has been able to argue, reasonably, that it is primarily for the French and Dutch governments to make proposals about how to restart the interrupted ratification procedure. At next year's European Council, Mr. Brown will probably find himself called upon to be more specific about British intentions. He is very unlikely indeed to be among those arguing that as a next step a new European Constitutional Treaty should replace the old one rejected in France and the Netherlands last year.

Brendan Donnelly
The Federal Trust

2. Eurozone Governance: Time to act!

In the year since the failure of the French and Dutch referendums, discussion about the state of the EU-12 has been dominated by contending views about politics rather than economics. Yet the decline of EU politics can only be understood in its wider economic context. Not only has the EU failed to deliver the growth and jobs it once promised, but high unemployment at the core of the Eurozone dates back nearly two decades and has become institutionalised.

A decade ago, the single currency appeared to promise a quite different picture. But the effective adoption of the euro coincided with the recession of 2000-01 from which America emerged relatively quickly and the Eurozone did not. Indeed, by 2003, quarterly growth rates in several core eurozone countries were negative. The European Central Bank was regularly criticized for its obsession with inflation targeting and its inability to be more proactive in its monetary stance. Attempts by Ecofin and the EU's Economic and Monetary Affairs Commissioner to enforce fiscal discipline on recalcitrant member states gave rise to increasingly heated exchanges over the Stability and Growth Pact (SGP). Attempts to 'restart' Lisbon have been unsuccessful. In countries like Italy, it is conceivable that wage-drift, stagnating productivity and growing unemployment could threaten the country's adherence to the euro in the long term.

Meanwhile, successive ministerial summits have witnessed almost continuous rows over the size and composition of the EU budget; Britain's reluctant agreement in 2005 to forego part of its rebate has not solved the underlying problem of tailoring budget priorities to meet 21st century needs. In short, the political troubles of the Union must be seen against a background of growing economic difficulties and disagreement.

The inadequacies of current arrangements

The current arrangements for governance of the common currency are grossly inadequate, and the economic objectives of its main actors are contradictory. There are three main areas in which improvement in eurozone governance is badly needed: monetary policy, fiscal policy and labour market reform.

Consider labour market policy. The prevalent view in Brussels is that growth with full employment is best achieved by promoting supply-side policies of labour market flexibility rather than in boosting aggregate demand. Yet various studies, including the *OECD Employment Outlook 2006*, suggest that there is no correlation between removing employment protection legislation (EPL) and increasing employment; eg, countries like Sweden and The Netherlands which have strong EPL have low unemployment. What seems to work is a combination of 'active labour market policies' (eg, strong support for education, skills training, job placement), high unemployment benefit contingent upon job search and 'flexible' job hours; eg, recognising the importance of the 24/7 economy. But such measures, desirable though they may be, are of little use where demand is deficient. In effect, it is impossible to go from high to low unemployment under conditions of economic stagnation.

Fiscal policy raises different issues. The EU's budget may be foolishly skewed towards supporting agribusiness, but its inadequate size and the requirement that it must be balanced annually make it a very weak tool of policy. In the Eurozone, fiscal policy is treated as the exclusive competence of member states, with state-level spending constrained by the Stability and Growth Pact (SGP). The alleged advantage of such tight budgetary discipline is that fiscal stabilisation can be left entirely to 'automatic fiscal stabilisers', and that the continuous reduction in public debt implied by the balanced budget rule will promote business confidence and boost private investment.

Most economists would argue that aiming at a zero budget deficit over the cycle is deflationary, just as the 3% ceiling on deficits is arbitrary numerology. If the Council wants to limit member-states' stock of debt, the relevant number to monitor is the ratio of debt to GDP. Similarly, it makes little sense to argue that an economy can be fiscally kick-started by automatic stabilisers, particularly when the effect of automatic stabilisers is weakened as taxation becomes less progressive.

Of the three areas of policy, the only one in which competence is assigned to the highest level is monetary policy, and this is a necessary consequence of monetary union. Criticisms of the ECB are well-known. Just as with the Council and the SGP, the ECB is obsessed with an inflationary spectre from the world of yesterday. Today's world is one of savings surpluses and deflationary dangers, particularly if a major slowdown in the US triggers a new and possibly worldwide recession.

New Policies

If the eurozone is to streamline its governance, what should it be aiming for? Early theoretical work on the monetary unions emphasised the need for both monetary and fiscal policy to be set centrally. The problem of running the eurozone on the basis of monetary policy alone is made all the more difficult by the ECB's deflationary bias. Since currency adjustment is no longer available to member states as a policy instrument, adjusting to an asymmetric shock depends on regional wage adjustment or

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on labour migration. But labour migration in the EU is slow, so that real wage adjustment at national level is crucial. Under conditions of very low inflation and sticky money wages, real wages cannot easily fall—as would appear necessary in the Italian case. And with low levels of investment, labour productivity cannot easily grow faster than wages. In short, the Union's obsession with fighting inflation makes it all the more difficult for member states to adjust.

If the Eurozone is to thrive three things are required. First, the Eurozone's deflationary bias must be scrapped. This would mean, minimally, reforming the ECB and the SGP. The ECB could learn lessons from both the Bank of England and the US Federal Reserve: the Monetary Policy Committee of the former includes not just bankers but independent economists while the Fed is bound by statute to consider growth and employment as major policy objectives.

The second necessary step in countering deflationary bias is the replacement of the SGP by some form of 'Sustainability Council' charged with monitoring member-states' stock of public debt. It is quite absurd to invoke the deficit procedure against two countries in breach of the 3% budget limit where, say, public debt in one is equivalent to 120% of GDP but only 40% in the other.

Thirdly, it is utopian to believe that a Federal European Budget similar to that of the US or Canada will emerge in the foreseeable future. Nevertheless, the current budget could be doubled with relative ease as suggested in a recent paper by Charles Goodhart, formerly chief economic advisor to the Bank of England.[1] The current budget is capped at 1.24% of combined EU GDP; in practice the figure is 1%. An immediate source of extra funding is *seigniorage* of the ECB, estimated annually to be about 0.5% of combined GDP. A further 0.5% could be raised by allowing Brussels both to borrow internally, and to issue paper on the international market in the same way the US Treasury emits bonds and bills.

But if the size of the budget is to increase, two things must happen. First, its composition must change drastically and emphasis must be placed not merely on supporting the Lisbon agenda but on providing the EU with better social and economic infrastructure, particularly in those new member states which need it most. Secondly, funding the budget must become more progressive. Implementing Spain's recent proposals to graduate contributions on the basis of per capita income would do much to convince the EU's citizens that Europe is serious about implementing a more 'social' agenda.

Finally, and more generally, politicians must accept that the long term success of the eurozone depends on continuing to move towards a federal structure. In the absence of an effective economic structure; (ie, a common currency, a Central Bank and, crucially, a federal budget controlled by Parliament), the notion of 'eurozone governance' remains at best a fragile shell, increasingly likely to be pulled apart by the growing centrifugal forces amongst its member states. As the danger grows of recession in the US, it's time for the EU to act.

George Irvin,
Former UHD Professor of Economics at Institute of Social Studies, The Hague

1 See Goodhart, C (2006) 'Replacing the Stability and Growth Pact' (draft) London School of Economics, 9 February 2006.

3. What prospects for an European energy policy?

A new Common Energy Policy (CEP) seems to be in the horizon. The most recent Commission's Green Paper[1] and the European Council Spring 2006 Report[2] are seen by some analysts as the foundations of a genuine CEP. EU member states have made strong commitments to both the external and internal aspects of EU energy policy. However, their top priority seems more likely that of a coherent external approach to securing Europe's energy supply rather than great improvements in the completion of an internal energy market (IEM).

EU member states have now recognised how the EU has proven to be a "fragmented actor" with little influence over international markets. In the aftermath of the Russian-Ukraine gas dispute at the beginning of this year it was clear that Europe was facing an increasing dependency on imports, especially from the unstable economies of Russia and the Middle East. The European Union is also increasingly concerned about the repercussions of excessive energy use on environment and global warming.

In this regard, the external-related priorities identified by the Commission's green paper have been welcomed by member states. They have agreed upon the need for a clear and "proactive" external common policy to secure energy supply and to meet the global challenge of climate change. In these two areas, action at a Community level is believed to add real value to 25 national separate policies. In the light of increasing EU dependency on imports[3], a concerted European energy diplomacy seems to be the best route to securing and diversifying energy sources. Ideally, it will involve the establishment of partnerships with both the main producers (Russia, OPEC) and consumers (China and India), and the development of the capacity to react effectively to external crisis situations through the establishment of a network of energy correspondents. Furthermore, as an important international environmental actor the EU is in a privileged position to encourage worldwide co-operation on energy efficiency, research and development of new technologies in multi-lateral fora as the International energy Agency (IEA) and the G8. An expansion of the geographic scope of the EU Emissions Trading Scheme and an international agreement on energy efficiency, both suggested by the Commission in its Green Paper, would equally enhance the EU's weight in the international scene.

However, the European Commission argues that any effective external energy policy will be dependent upon the progress made with internal policies, namely the progress on the IEM. The

Commission has long believed that an open market and the establishment of cross-border energy companies play an important role in guaranteeing Europe's energy security. The process of internal liberalisation that was initiated in 1996 is due to be completed by the 1st July 2007 (directive 2003/54/EC). However, considerable progress still has to be made by member states with regards to the implementation of EU energy directives. In France, Italy and Spain, for instance, an upsurge of "economic patriotism", has seen deliberate governmental interference in promoting energy "national champions". That was the case of the merger between Gaz de France and Suez in France and Gaz Natural and Endesa in Spain. Very little has been done by the Commission to fine energy companies for distorting the market, despite evidence of infringements.

In its recent Green Paper, the Commission has proposed a package of measures to improve efficiency in the functioning of the "patchy" internal market so that consumers and producers can both benefit from it. Some priorities identified by the Commission have been well received by member states, for instance, the development of a European grid code to ensure common rules for regulating cross-border trade, the establishment of a *European Energy Supply Observatory* and the publication of strategic analysis of the policy to ensure security of supply in the event of a crisis. Nevertheless, other proposals appear to be more difficult to gather member states' consent and to be implemented. For instance, the creation of a single European regulator has been source of some controversy. In a recent interview to the FT[4], the European Commission President Mr. Barroso seemed determined to persuade member states of the need to strengthen the power of central energy regulation given the fact that national regulators are too close to national governments and power companies. Yet the idea has been regarded as premature by the majority of national governments, who want to ensure that regulating authorities remain primarily nationally based.

It is no secret that some EU member states have been pressing the European Commission doubt the added value of taking action at the EU level. They cite in their defence the principles of subsidiarity and proportionality. When it comes to the challenge of implementing common rules and standards, some national governments have been warning the Commission to act very cautiously.

In short, the prospect of linking the internal energy market with the realisation of external policy goals is not a very realistic one, even though such a link would certainly bring more efficiency and consistency to a common energy policy. Nevertheless, progress seems likely in the external sphere over the forthcoming months. The EU-Russia negotiations in Lathi were less productive than some had hoped, but the progress achieved was a modest success for Europe's energy diplomacy. The EU heads of State and Government's Action Plan on a CEP to be agreed by March 2007, will certainly emphasise the instruments to achieve a coherent external policy to secure Europe's energy supply.

Joana Cruz
The Federal Trust

1 European Commission, 'A European Strategy for Sustainable, Competitive and Secure Energy", COM(2006) 105 final, March 2006
2 European Council, "An External policy to serve Europe's energy interests", Summit Report, March 2006
3 EU's import dependency is currently 50% and according to the Commission estimates it can reach 70% by 2030
4 Financial Times, «Barroso takes whip to energy monopolies», 12th September 2006

4. News from the Federal Trust

New Reports

- "The Governance of the Eurozone"

The Federal Trust Working Group Report on the Governance of the Eurozone was recently launched in Brussels.

As the Group's Chair, Sir Stephen Wall, writes in the report's introduction - "This is not a timid report. But nor is it an intemperate one." The report's recommendations might, if implemented "give fresh impetus to political union, not for its own sake, but to help deliver the coherent governance Europe needs", he writes.

The Report is available in electronic form at www.fedtrust.co.uk, and in hard copy.

New Policy Commentary

- "Four routes to the new Europe; Possible solutions to the problems of the Constitutional Treaty", by Richard Laming, Federal Trust Council Member.

All Policy Briefs and Policy Commentaries are available for download at www.fedtrust.co.uk/publications.

Seminar Series with Chatham House

The Federal Trust is planning, with Chatham House, to host a series of seminars in the New Year.

Topics will include - European Energy Policy, the European Budget, and the status of the Constitutional Treaty.

Details will be announced in due course.

Working Groups

Two Federal Trust Working Groups are currently meeting. Final reports for both will be published in the New Year:

- Democracy, legitimacy and accountability in the EU

- EU Justice and Home Affairs

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