



CER Bulletin

Issue 86 | October/November 2012

Eurozone: Are the building blocks falling into place?

By Simon Tilford

Also in this issue

What Romney would mean for Europe

By Clara Marina O'Donnell

Cameron's choice: Play to the gallery or keep Britain safe

By Hugo Brady



Eurozone: Are the building blocks falling into place?

by **Simon Tilford**

On the face of it, September was a good month for the euro. For once, market expectations were met. The European Central Bank (ECB) belatedly opened the way for action to address the ruinous polarisation of government borrowing costs in the eurozone. Germany's Constitutional Court removed the last obstacle to the deployment of the European Stability Mechanism. The Commission put forward proposals for a eurozone banking union. And Dutch voters resisted the clarion call of political populism. Will the market rally that greeted these developments be sustained, or will it prove as transient as previous ones? Cautious optimism is warranted, but more is needed to convince investors of the irreversibility of the euro.

The ECB's announcement prompted a steep fall in Spanish and Italian bond yields and a strengthening of the euro. For many, the ECB had demonstrated that it would do everything necessary to save the single currency. For others, it marked the end of central banking independence and presaged the monetisation of debt and a surge of inflation. The reality is more prosaic. The move certainly marked an unequivocal intellectual victory for Mario Draghi. The Italian won almost unanimous support for the move; Bundesbank chief Jens Weidmann was the only dissenter. But the announcement is less than it appears. And the political stalemate at the heart of the euro crisis remains unresolved.

The ECB's readiness to purchase potentially unlimited quantities of government debt marks

a victory for those who have long called for such action to counter the break-up risk responsible for the struggling eurozone economies' inflated borrowing costs. Investors believe that there is a chance that Italy and Spain will ultimately be forced out of the currency union and are thus demanding a hefty premium to insure against this eventuality. This feeds convertibility risk by weakening countries' fiscal positions and raising private sector borrowing costs (government bond yields set the cost of capital for the private sector). The ECB announcement represents an acknowledgement of the perversity of countries in deep recessions paying the highest borrowing costs and a repudiation of the idea that the high interest rates largely reflect governments' credibility problems. Finally, it demonstrates a willingness to act in the

interests of the eurozone as a whole, and to isolate Germany if necessary.

However, there are qualifications. A declared willingness to buy bonds will not be enough to bring about a sustained fall in government borrowing costs. For this, the ECB will actually have to buy large quantities of debt. There are some formidable obstacles to this happening. First, any government wanting to benefit from the ECB's scheme will have to sign up to strict conditions. They will not necessarily have to apply for a full programme of the kind in place in Greece, Ireland or Portugal, but they will have to agree to a macroeconomic adjustment programme, which will include fiscal austerity imposed by the Commission and monitored by the IMF.

Second, all 17 eurozone governments will have to approve each programme, opening the way for national parliaments to veto those that are seen as insufficiently tough. In short, Weidmann may have been in a minority of one on the ECB's Governing Council, but the German parliament has an effective veto over the aid programmes that must be in place before the ECB can act.

The need to attach conditionality is understandable; other governments have to be confident that countries whose debt the ECB buys will not slow the pace of reforms. But there is a risk that in the drive to make the programmes acceptable to national parliaments, struggling countries will be required to sign-up to excessive fiscal austerity. The experience of the three countries under the existing bail-out programmes strongly suggests that this would be self-defeating. They have persistently missed their deficit targets as austerity has pushed them into deep economic slumps.

There is little reason to believe that Italy or Spain would fare any differently. For example, were ECB purchases of Spanish bonds to be made conditional on Spain actually meeting the Commission's deficit targets (rather than simply paying lip-service to doing so), Spain would be forced into further cuts in public spending. The result would be a deepening of the country's slump and a worsening of its fiscal position. It is a moot point whether the Spanish would accept a humiliating loss of sovereignty in return for a commitment to buy their bonds if they abide by terms that are almost certain to prove unrealistic.

In reality, the ECB would be unlikely to cease bond purchases if a country did breach the terms of its programme for fear of plunging the eurozone into a potentially fatal financial crisis, but this would present its own set of problems.

The spectacle of the Bundesbank being outvoted has already prompted fierce criticism in Germany. If the ECB were to continue with bond purchases in the face of breached conditionality, it would become much harder to win German support for subsequent programmes for other countries. Moreover, it could make it even less likely that the Germans (and others) would agree to the other indispensable institutional building blocks of a solution to the crisis, such as a banking sector union and eventually some kind of fiscal union.

The ECB's move combined with the ESM is not enough to dispel investors' fears over a break-up of the eurozone. The central bank has done as much as the political constraints permit: the ball is now in the governments' court. They must agree a level of conditionality that makes economic sense but which is also acceptable to both sides. This will not be easy: if conditionality is excessively tight, countries are likely to balk at applying for ECB support; if it is deemed insufficiently demanding by others they will refuse to sign off on them. Far from wading into the market to dispel convertibility risk, there is a risk the ECB could end up doing little. And the longer there is no bond-buying, the more fragile the market rally will become.

“*The ECB's move combined with the ESM is not enough to dispel investors' fears over a break-up of the eurozone.*”

Besides, the ECB is powerless to address the core of the crisis: the failure of the eurozone's debtors and creditors to broker an equitable and economically viable burden-sharing agreement. No debt crisis has ever been solved by the debtors being forced to carry the full burden of adjustment, but that is what the eurozone's creditor countries are attempting to do. A workable solution requires the creditors, led by Germany, to make the case for a degree of mutualisation, be it in the form of a fully-fledged banking union or Eurobonds, or a combination of the two. With many Germans smarting at the Bundesbank being outvoted and increasingly fretful about the scale of their exposure to the crisis-hit countries, this would be a tall order for any politician in a run-up to a general election, let alone one as cautious as Angela Merkel.

Simon Tilford
Chief economist, CER

What Romney would mean for Europe

by Clara Marina O'Donnell



As the US elections approach, Mitt Romney's sometimes bellicose rhetoric on national security is raising European eyebrows. But many in Washington believe that if the Republican contender were to become president, US policies might not differ much from the last four years. Despite Romney's strong criticism of Barack Obama, some of the challenger's views on foreign policy issues are similar to the president's. And the points on which they disagree may matter little: US presidents rarely implement their more outlandish campaign pledges. In any case, Congress will continue to set limits on US policy on issues such as the Arab-Israeli conflict and nuclear arms control, whoever the president. But, if Mitt Romney genuinely believes much of his foreign policy rhetoric, a Republican victory in November could mean difficult times for transatlantic relations.

For a full analysis of this issue, see the forthcoming CER publication 'Obama II vs a Romney administration: What implications for Europe?' by Clara Marina O'Donnell.

The former governor has, for example, identified Russia as America's "number one geopolitical foe". He considers Obama's 'reset' with Moscow to have been a failure. He opposed ratification of the New START treaty on strategic weapons reductions because it supposedly allows Russia to expand its nuclear arsenal – Romney has notably warned that the treaty, unprecedentedly, allows Russia to mount intercontinental ballistic missiles on bombers. The Republican candidate has also strongly criticised Obama's missile defence plan as less technologically reliable and ambitious than that of George W Bush, and for downgrading the involvement of US allies Poland and the Czech Republic.

Europeans, however, welcomed the US-Russia reset. Many of them worry about Vladimir Putin's authoritarianism and non-co-operation on Syria. But most Europeans think the reset has made Russia more helpful on Afghanistan and Iran. They like New START, and many EU governments will have been confused by Romney's concerns about bombers equipped with intercontinental ballistic missiles. Indeed it would be impossible for a bomber to take off with such a heavy load. Even EU countries that are more hawkish on Russia are likely to see Romney's views as unnecessarily antagonistic. Initial concerns in Poland and the Czech Republic about the Obama administration's commitment to their security

have been largely addressed, after the US placed fighter jets in central Europe and started holding regular military exercises there. And Poland has been working on its own reset with Russia in recent years.

Romney promises to declare China a currency manipulator in order to encourage Beijing to revalue the renminbi (believing that its level hurts US industry). Europeans find many of China's trade practices frustrating, but try to avoid a confrontational approach with Beijing. EU governments would be particularly keen to avoid a US-China trade war in the midst of the eurozone crisis.

While most European countries have long wanted to end military operations in Afghanistan, Romney has criticised the Obama administration for leaving too soon and trying to talk to the Taliban. Romney wants to keep the detention camp at Guantanamo Bay and 'enhanced interrogation techniques', while Europeans have welcomed Obama's efforts to eliminate both.

On Iran, Romney has made clear his willingness to use force to stop Tehran from developing a nuclear weapon – while most Europeans would not go that far. Romney's rhetoric on the Middle East peace process is also at odds with European views. The Republican contender has opposed President Obama's attempts to stop Israel building illegal settlements – efforts which have been applauded by most EU states. Romney has also pledged to reduce financial assistance to the Palestinians if they form a unity government that includes Hamas. The EU on the other hand, despite its dislike of the militant group, is willing to work with a Hamas that is reconciled to Fatah and renounces using force against Israel.

But on several foreign policy issues (including those above), Romney's views appear changeable and somewhat contradictory – perhaps because his team includes both neoconservatives who backed George W Bush's wars and realists with a more pragmatic perspective. So some of Romney's policy recommendations are in fact quite similar to those of the current US government. Like Romney, Obama says that he would – if necessary – use force to stop Iran obtaining a nuclear weapon. Like Obama, Romney would withdraw US troops from Afghanistan in 2014. Like the current administration, Romney is against US military intervention in Syria unless Bashar al-Assad's regime resorts to chemical and biological weapons. Romney is even willing to co-operate with Russia on missile defence as long as Russia is not given a 'veto' on US security – a position shared by Obama.

In any case, how many of his controversial policies would Romney implement if he won the election? Many presidential contenders, after all, have walked away from campaign pledges: Obama also promised to label China a currency manipulator, while George W Bush was against using US troops for nation-building.

Mitt Romney already has a track-record of about-turns on policy. Although he now questions whether humans are responsible for climate change, he previously strove to reduce greenhouse gas emissions. And although Romney now lists Obama's raid against Bin Laden among the president's few foreign policy successes, the challenger opposed covert operations in Pakistan when Obama first voiced the idea in 2007.

“*Congress will continue to set limits on US policy on issues such as the Arab-Israeli conflict and nuclear arms control, whoever the president.*”

Romney's endorsement of increasingly hawkish objectives abroad (and conservative policies at home) seems designed to win over sections of the Republican party which were uncomfortable with his initially moderate positions. The former governor's policies and views could change again, once today's rhetoric has served its purpose. Given the candidate's malleability, and his pledge to strengthen ties with America's allies, the Europeans may have an opportunity to shape a President Romney's foreign policy views, on issues such as Russia and Iran.

But even then, Mitt Romney's room for manoeuvre would probably be constrained by US domestic politics. Over the last four years, an uncompromising Congress has hampered President Obama's efforts on numerous domestic and foreign fronts – including further cuts in nuclear weapons and shifting US policy towards the Middle East peace process. Republicans within Congress might be more conciliatory towards a Republican President. But US politics – which two leading US scholars, Thomas Mann and Norman Ornstein, have characterised as “utterly dysfunctional” – are set to remain ideologically polarised, notwithstanding who wins the presidential elections.

Clara Marina O'Donnell
**Research fellow, CER and non-resident fellow
The Brookings Institution**

Cameron's choice: Play to the gallery or keep Britain safe

by Hugo Brady



Britain has a decision to make that has major implications for both its security and its influence within the EU. Should it opt out of most EU co-operation on crime and policing by 2014? It can do so thanks to a special deal won by Britain in negotiations on the EU's Lisbon treaty in 2009. MPs look likely to say 'yay' when parliament votes on the matter next year: anti-EU feeling is running high in Westminster.

If Britain uses this 'block opt-out', it will lose access to a raft of cross-border agreements and databases designed to help EU countries maintain security and better manage the free flow of people between them. UK authorities will no longer be able to use the European arrest warrant (EAW) with which they have prosecuted hundreds of criminals who would otherwise have gone unpunished.

If Britain does not opt-out, after 2014 the European Court of Justice (ECJ) will have a say over how police, prosecutors and courts across the EU co-operate to investigate crime, organise extraditions, share criminal records and exchange evidence. The Lisbon treaty will give the European Commission, for the first time, the power to enforce over 130 such agreements. EU judges will be able to interpret their exact meaning, as they do with the rules of the single market.

Most EU countries have criminal justice systems based on a mix of the Roman civil law

and the Napoleonic legal code. Of the large member-states, only Britain uses common law, a fundamentally different system, where the defence and prosecution argue cases before a neutral judge and jury. Other governments recognise that this entitles Britain (and Ireland, also a common law country) to special treatment: both opt-in to EU crime and policing measures on a case-by-case basis.

But Lisbon has shifted the emphasis of EU criminal justice policy away from 'co-operation' towards more 'integration', by abolishing national vetoes and giving the Union's institutions more powers. Over time – the thinking in Whitehall goes – EU judges might undermine Britain's common law traditions by handing down harmonising rulings that favour the continental model of criminal justice. This, along with strong opposition in the Conservative Party to the influence of European courts in general, makes it likely that Britain's prime minister, David Cameron, will use the block opt-out.

For a full analysis of this issue, see the forthcoming CER publication 'Cameron's next European 'own goal': Leaving EU police and justice co-operation?' by Hugo Brady.

That would be a mistake. First, UK officials imagine that Britain's size and importance mean that it can automatically opt back in to around 50 EU anti-crime measures, including the arrest warrant, once the block opt-out is triggered. That way the government could secure access to co-operation and data valued by Britain's police while limiting the country's exposure to future ECJ rulings. This is wrongheaded. The European Commission is likely to attach tough conditions to an attempted partial re-entry, and Britain's negotiating stock in Brussels is low due to its perceived unhelpfulness during the eurozone crisis. Countries in the EU's Schengen area of passport-free travel have previously blocked Britain from joining Frontex, the EU's border agency, and the so-called VIS, a common database of visa records. Why should they now acquiesce to British cherry-picking in policing and justice?

Second, Britain has done a lot to shape the EU's internal security agenda. The current head of Europol (the EU's police office), Rob Wainwright, is British; as have been the last two presidents of Eurojust (its prosecution office), and the last two director-generals of the Commission's justice and home affairs directorate. For a country that is not in Schengen, possesses a minority legal system and selectively opts-out of common rules, this is a remarkable diplomatic success.

Eurosceptics support the block opt-out as a step towards their goal of moving Britain to the

fringes of the EU. Such a move would annoy even traditional allies like the Netherlands and Sweden. And it would greatly reduce British influence on this crucial area of EU policy-making.

“*Over time – the thinking in Whitehall goes – EU judges might undermine Britain's common law traditions by handing down harmonising rulings.*”

David Cameron should remember that the UK will still have to apply EU free movement rules, under which millions of EU nationals reside legally in Britain. However, if he mishandles the block opt-out question, Britain may be unable to work effectively with other EU countries on extradition and basic security questions. Stephen Lander, a former head of Britain's intelligence service, MI5, underlined this risk in a recent letter to the government, co-signed by several former UK police chiefs.

Hence the prime minister must choose: either to face down the eurosceptics or explain why it is in Britain's interest to weaken co-operation with other EU countries on serious and organised crime.

Hugo Brady
Senior research fellow, CER

CER in the press

The New York Times

18th September 2012

“Germany's renewal of the concept of political union reflects the fact that the German political class has become more integrationist as the euro crisis has progressed,” said Charles Grant, director of the CER.

The Guardian

18th September 2012

“Afghanistan turned out a lot less safe than they thought it was going to be, but the Germans toughed it out, changed their rules of engagement, and fired back,” said Tomas Valasek of the CER.

The Guardian

16th September 2012

German taxpayers stump up a “solidarity surcharge” of 5.5 per cent of income tax to fund the hefty costs of unification in an arrangement due to last until 2019. “East Germany might well need another trillion,” said Katinka Barysch, deputy director of the CER.

The Wall Street Journal

15th September 2012

“Greece isn't the cause of illegal immigration [into the EU], it's a serious patch of vulnerability,” said Hugo Brady of the CER.

Financial Times

13th September 2012

“Faced with the lack of demand in Europe, the name of the game for many European defence companies has been to try and get into other markets like the US,” says Clara Marina O'Donnell of the CER.

Financial Times

6th September 2012

“One question is whether the benefits from the bond buying are going to be enough to offset the damage inflicted by the conditionality attached,” said Simon Tilford, chief economist at the CER.

The Daily Telegraph

31st August 2012

“Countries facing depressions and rapidly weakening inflation typically face very low borrowing costs,” said Simon Tilford of the CER.

BBC News

10th August 2012

“Three views of the UK are now common across Europe: that it is unreliable and unconstructive; that it is an active distraction from solving the region's worst crisis since World War II; and that it appears to be heading for the EU's exit door,” said Philip Whyte of the CER.

Recent events



ABOVE: Igor Yurgens, chairman of the management board of the Institute of Contemporary Development

12 July

Allianz-CER dinner on 'Can Russia reform, and what are the implications for the EU?'

*Speaker: Igor Yurgens
Brussels*

26 June

CER 14th birthday party, hosted by the Irish Ambassador

*Bobby McDonagh
Speaker: The Rt Hon William Hague MP
London*



ABOVE: The Rt Hon William Hague MP, foreign secretary



ABOVE: Martin Schulz MEP, president of the European Parliament

20 June

CER-Kreab Gavin Anderson breakfast on 'Democracy and the eurozone crisis'

*Speaker: Martin Schulz MEP
Brussels*

8 June

Allianz-CER lunch on 'Can the single market move Europe from austerity to growth?'

*Speaker: Michel Barnier
Brussels*



ABOVE: Michel Barnier, European commissioner for internal market and services

Events

24 September 2012

CER/BNE/Open Europe fringe event at the Liberal Democrats party conference: 'Europe, from crisis to growth' Edinburgh room, Hilton Metropole, Brighton 18.15-19.45

Speakers: The Rt Hon David Laws MP, Vicky Pryce, Simon Tilford and Phillip Souta (chair)

30 September 2012

CER/BNE/Open Europe fringe event at the Labour party's conference: 'Europe, from crisis to growth' Exchange 2-3, Manchester Central, Manchester, 17.45-18.45

Speakers: The Rt Hon Douglas Alexander MP, Chris Leslie MP, Charles Grant (chair) and Mats Persson

9 October 2012

CER/BNE/Open Europe fringe event at the Conservative party's conference: 'Europe, from crisis to growth' Hall 5, International Conference Centre, Birmingham, 19.30-21.00

Speakers: Harriett Baldwin MP, David Lidington MP, Mats Persson (chair) and Charles Grant

18 October 2012

CER/Kreab Gavin Anderson breakfast on 'Strengthening Europe's economy through climate policies' Brussels

Speakers: Connie Hedegaard, European commissioner for climate action

For further information please visit

www.cer.org.uk