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CENTRE FOR EUROPEAN REFORM

The spectre of default stalks the eurozone

by Simon Tilford

A popular narrative has taken hold across much of the eurozone. The economic situation, so the story goes, is improving, or at least bottoming out, and the necessary institutional reforms are being put in place. True, progress is messy and imperfect given the politics, but the currency union is on the right track. This narrative, however, is complacent. The economic situation remains grim, not least because of a failure to strengthen the region's banks. And there is a disconnect between the scope of the reforms under discussion and the scale and immediacy of the crisis. This bodes ill for the solvency of Italy and Spain.

Europe, it seems, has become anaesthetised to bad news. Six consecutive quarters of economic contraction, record unemployment and rapidly rising debt burdens trigger little reaction from policy-makers. By contrast, an easing of the pace at which unemployment is rising, or tentative signs that there could be respite from outright recession, are cited as evidence of economic recovery. The reality, however, is that the Spanish and Italian economies will shrink by a further 2 per cent in 2013. Greece's is on course to contract by an additional 5-7 per cent and Portugal's by 3-4 per cent. Even Ireland will struggle to grow. The core's prospects are not much better. Germany is growing but the country's exports are faltering in the face of slump across the eurozone and a rapid slowdown in China, and it is far from clear that domestic demand will take up the slack.

The European Commission points to declining trade deficits across the eurozone periphery as evidence of improved competitiveness and hence of growth prospects. It is true that exports are growing (quite rapidly in Spain's case), but not by enough to offset the decline in domestic demand. Far from being on the mend, the economic crisis across the south is deepening. Real interest rates are increasing from already high levels, as inflation falls. Mounting bad debt is forcing banks to rein in lending, resulting in a wave of corporate insolvencies and more bad debt.

Eurozone policy-makers should be concentrating on bringing down borrowing costs. If 'competitiveness' is to mean anything other than a zero-sum game (in which countries compete to beggar their neighbours by cutting wages), it has to mean improved productivity. But Spain and

Italy will struggle to raise productivity relative to Germany if their businesses (and governments) have to pay three times as much to borrow as their German counterparts. For example, if businesses in the struggling German state of Saarland faced borrowing costs three times those of booming Bavaria, Saarland would remain depressed indefinitely, and dependent on transfers from stronger parts of Germany.

Spain and Italy cannot rely on transfers from the rest of the eurozone, but face a rapid worsening of their debt burdens as nominal GDP (growth plus inflation) falls. This so-called denominator effect – where declining GDP increases a country's debt burden as businesses, households and governments have less income with which to pay back debt – receives too little attention. Over the last year, Portugal's and Spain's debts rose by 15 percentage points of GDP, and Ireland's and Greece's by 18 and 24 points respectively. In Italy, which ran a budget deficit of just under 3 per cent of GDP in 2012, the ratio of debt to GDP rose by 7 percentage points (to over 130 per cent).

Even if Italy's nominal GDP is flat over the next year, the Italian government will have to run a primary budget surplus (a surplus before the payment of interest) of 5 per cent of GDP just to stabilise the public debt ratio. It is certainly trying – Italy's primary surplus is currently around 2.5 per cent of GDP – but the result has been a deep recession and a compounding of the denominator effect. The picture is even worse in Portugal and Greece, and not that much better in Spain.

Nominal GDP across the eurozone periphery needs to recover rapidly if these countries are to remain solvent. The reforms of eurozone governance in the pipeline are insufficient to ensure this happens. Although the terms of the banking union are still under negotiation, it is pretty clear that whatever is finally agreed will not break (or even significantly dilute) the link between banks and governments, because it will not include joint liability for eurozone banks. Unless there are big shifts in the bargaining positions of the various governments, the new supervisory body will have a big say over which banks should be closed down or bailed-out, but the money to do this will still be largely national. Only after creditors and depositors have been 'bailed in' and national governments have paid their share will 'federal' money be available, and then the amount is unlikely to be enough to act as a credible fiscal backstop. The mooted figure of €60 billion sounds large, but outstanding bank credit across the eurozone stands at €16.5 trillion. Only a tiny proportion of this would need to go bad to overwhelm the bail-out fund.

The prospect of the eurozone establishing a central budget able to provide effective counter-cyclical financing to hard-hit governments is also remote. A Franco-German paper issued in May proposed the establishment of a fund to provide limited and conditional financial support to struggling member-states, so long as they abide by a long list of policy prescriptions – from reforms of labour market and retirement systems to measures to boost public sector efficiency. Such a fund could theoretically form the embryo of a more substantive budget, but as currently proposed would do little to solve the problem.

> *"Far from being on the mend, the economic crisis across the south of the eurozone is deepening."*

By activating the Outright Monetary Transactions (OMT) or a wider programme of quantitative easing, the ECB could bring down Italian and Spanish borrowing costs by enough to stabilise these countries' debt burdens. But the central bank might not be able to do either, not least because of opposition from a sceptical Bundesbank. If so, it is possible that Italy – home to the third biggest government debt market in the world – or Spain will at some point be unable to borrow enough money to meet their financing needs. The fact that Italy has limited foreign liabilities does not preclude this possibility. After all, Italian banks have to be willing and able to buy the debt the Italian government issues.

Sovereign defaults cannot be ruled out. The eurozone might be able to agree further loans to Portugal – which is losing its battle to comply with its existing bail-out programme – but the sums needed to bail-out Spain or Italy or both could overwhelm the European Stability Mechanism (ESM). Unless the ECB then stepped in to act as a fully-committed lender-of-last-resort to these countries' governments, or the ESM was expanded to become, de facto, a common borrowing instrument, default would become inevitable. At this point Spain and Italy would have to quit the euro, renege on their debts, and print the money needed to keep their banks afloat. The German election could well open the way for the more radical policies needed to prevent the crisis reaching this point. But as things stand, the current optimism looks misplaced.

Simon Tilford
Deputy director, CER

Edward Snowden's '1984'

by Ian Bond

From his refuges in Hong Kong and Moscow, former US National Security Agency contractor Edward Snowden has given the world one shocking revelation after another: the American government spies on Americans! The American government spies on its allies! The Germans are in bed with the Americans! The British spy on everyone!

The British government has wisely kept its head down, but most of Europe has reacted with real or simulated shock to this evidence that the US and Europe are separated by more than just an ocean. Some politicians urged the Commission not to start the negotiations on the Transatlantic Trade and Investment Partnership (TTIP), while some Members of the European Parliament (MEPs) threatened not to ratify it.

There are two aspects of the story, often conflated, which raise different issues. The first is the extent to which preventing terrorism or organised crime justifies collecting data or 'metadata' (that is all information about a communication except its content) from everyone. The second is the morality and the value of spying on allies.

US comments on the issue of security versus privacy have mostly focused on what Snowden has said about the NSA's domestic spying, and on the extraordinary access granted to contractors. Few care about the impact on Europe.

With its memories of Nazi and Communist secret police, Germany has shown the most sensitivity about violations of privacy. Chancellor Merkel has steered a careful course, defending the need for intelligence services in a democracy and stressing the value of America as an ally. But at the same time, as criticism grew, she proposed in an interview on July 14th that there should be strict new EU rules on privacy and data protection, replacing the current mishmash of national interpretations of the 1995 data protection directive. Merkel complained that Facebook avoided strict German privacy laws by operating under a more relaxed regime in Ireland, and that the British had a different philosophy on privacy from the Germans. Indeed, the UK has been a major obstacle to the Commission's efforts to update the 1995 directive.

Much European commentary on whether allies should spy on allies has been either hypocritical or naïve. After the US had accused France earlier this year of hacking US computers for economic intelligence, it was perhaps natural for President Hollande and Foreign Minister Fabius to respond in kind; but when *Le Monde* revealed that the French external intelligence service, the DGSE, was also sucking up data in bulk, French leaders were left looking foolish.

Equally, President Obama's flippant first reaction ("I guarantee you that in European capitals, there are people who are interested in, if not what I had for breakfast, at least what my talking points might be") showed little awareness of European sensitivities. More positively, US Attorney General Eric Holder agreed with EU Commissioner for Justice, Fundamental Rights and Citizenship Viviane Reding to set up an expert group to "establish the facts surrounding these [NSA] programmes" and report back in the autumn – usefully taking some heat out of the issue by postponing it.

The responses of EU institutions to the Snowden story have been inconsistent. EU High Representative Catherine Ashton issued a sober statement on July 1st that she was aware of the reports, had sought urgent clarification from the US and would not make any further comment until there was more clarity.

Viviane Reding, however, notwithstanding her agreement with Eric Holder to set up an experts group, told a public meeting on June 30th: "We cannot negotiate over a big transatlantic market if there is the slightest doubt that our partners are carrying out spying activities on the offices of our negotiators." TTIP negotiations will be tortuous enough, without holding the agreement hostage in this way. Fortunately, the EU's lead negotiator in the first round of talks in Washington did not repeat the idea.

Reding's comments risk encouraging those MEPs who are suspicious of free trade agreements or the US or both – those who held up agreements on US access to European banking data for the Terrorist Finance Tracking Programme, for example. MEPs have leverage because they must ratify any eventual TTIP agreement. Though British officials will assert that intelligence issues are beyond the EP's competence, opening markets in e-commerce and telecommunications will inevitably raise data protection and privacy issues. The Parliament signalled this in its July 4th resolution on the NSA surveillance programme, calling on the Commission "to ensure that EU data protection standards …are not undermined as a result of the TTIP".

Reactions to the Snowden affair show that Europe and America both need a serious debate about privacy and security in the internet age. When hundreds of millions of Facebook users post information about their lives in embarrassing detail, and tens of millions tweet their every thought, what does 'privacy' mean? When terrorism is nurtured in cyberspace, how do we counter it? Jan Fleischauer pertinently asked in *Der Spiegel* whether, if Germany suffered a terrorist attack because of delays in sifting the metadata of the perpetrators, the Justice Ministry would be brave enough to explain that such attacks were the price to be paid for the right to determine the fate of our personal information.

"Europe and America both need a serious debate about privacy and security in the internet age."

The debate in the European Parliament would be better informed if the MEPs had some mechanism for receiving classified briefing, along the lines of the UK's parliamentary Intelligence and Security Committee. A paper written for the Parliament in 2011 makes some sensible suggestions on how this could be done in relation to EP oversight of bodies like Europol, introducing the 'need to know' principle and security vetting into the EP.[1] These proposals could be extended to cover other sensitive areas. No doubt British ministers will turn pale at the thought, but the alternative is worse, given the ability of the EP to block international data sharing agreements which are vital in combating terrorism and organised crime.

Governments on both sides of the Atlantic should think harder about the costs and benefits of spying on allies. Writing in *Foreign Affairs*, Henry Farrell and Abraham Newman have kicked off a debate on whether the damage done to America's interests in Europe when it is caught spying on its allies outweighs the value of the intelligence acquired: the EU and US are close enough partners that the Americans are unlikely to have learned much from spying that they could not have found out by asking.

That is not true of some of the EU's other trade and diplomatic negotiating partners. Edward Snowden has caused tremendous damage to important intelligence programmes, but he has performed a useful service for the EU, in showing how much it needs to tighten up its security. Now the EU knows where some of the holes are, it should plug them, fast. More than one Big Brother is watching.

Ian Bond
Director of foreign policy, CER

1: Aidan Wills and others, 'Parliamentary Oversight of Security and Intelligence Agencies in the European Union', European Parliament, 2011.

Will the Dutch help Cameron to reform the EU?

by Rem Korteweg

To renegotiate the terms of Britain's EU membership, David Cameron must find allies. One of his targets is the Netherlands. In his January speech, Cameron applauded the Dutch government's effort "to examine thoroughly what the EU as a whole should do and should stop doing." The so-called subsidiarity review was recently published and spells out 54 policy areas in which The Hague feels the EU should be less involved – or not involved at all. Given that many European leaders have been sceptical about – or downright opposed to – Cameron's push for reform, Downing Street sees the Dutch review as good news. But if Cameron believes the Netherlands will support radical changes to the EU, he is mistaken.

It is not hard to see why Cameron thinks the Dutch are on his side. Like Cameron, prime minister Mark Rutte argues that "the time of an ever closer union in all policy areas is over". The Dutch review argues that the European Commission should not have a greater say over such areas as social security, pensions, criminal law and media pluralism. The Dutch oppose an independent eurozone budget and EU taxes. In general, the Dutch government believes the Commission should set broad objectives, and leave implementation to the member-states.

The Dutch, like the British, have always feared a European super-state, and they prefer a balance of power between the UK, France and Germany. The Netherlands shares Britain's free-market outlook and does not trust either the Berlin-Paris axis, or a powerful European executive, to always act in the best interests of the Dutch. Thus it fears both an over-zealous Commission and a 'Brexit'.

The Dutch subsidiarity review is also a response to growing euroscepticism at home – much like Cameron's referendum strategy. The populist leader of the Freedom Party, Geert Wilders, lost badly at the last general election, but his star is rising again. His gains have come at the expense of Rutte's right-of-centre VVD, much as Britain's UKIP has eaten into Conservative support. To steal Wilders' thunder, the opposition Christian Democrats have started talking about repatriating powers from the EU. The subsidiarity review is an attempt to appease this growing chorus.

However, the similarities end there. Unlike the British coalition, where the Conservatives dominate, Rutte's liberals are on an equal footing with the Social Democrats, with 41 and 38 MPs respectively. The VVD is more eurosceptic than its coalition partner, but the foreign minister in charge of the subsidiarity review, Frans Timmermans, is a senior Social Democrat and a staunch European. And as the Netherlands provides the chair of the Eurogroup (the eurozone group of finance ministers), it is difficult for the government to be overly critical of the EU. The Netherlands also has an overriding geopolitical and economic interest in remaining committed to the EU and in reaping the full benefits of the single market.

Consequently, the review's proposals are not as far-reaching as Cameron may have hoped. The review says, for example, that the EU should not intervene in forest policy, national flood management, or in rules governing air quality, school milk, tunnel safety or olive oil jugs. These are hardly bold ideas to reshape the way the Union works. Meanwhile, the Netherlands wants more European co-operation on defence, climate policy, energy, migration policy and cross-border crime, as well as a push to complete the single market and improve the efficiency and legitimacy of eurozone decision-making.

While Rutte and Cameron share much of their diagnosis on what is wrong with the EU, they differ over the treatment. Rutte dismisses the notion of opt-outs or repatriating powers, and says treaty change is neither possible nor desirable. Instead he has set his sights on reining in what he perceives as an overweening European Commission. His favoured instrument is subsidiarity. This principle – central to the EU treaties, but inadequately enforced – holds that the Union should act only when doing so achieves better outcomes than member-states acting separately at national level.

What reforms could Cameron propose, then, that the Dutch might support? One might be to give national parliaments a greater role in policing subsidiarity, for instance through the 'yellow-card' procedure. The procedure enables one third of national parliaments (or more) to ask the Commission to withdraw a proposal that they consider breaches subsidiarity. It could be strengthened into a 'red card', so that the request becomes an obligation to withdraw an initiative. Reducing the number of commissioners might also cull the number of unwanted Commission initiatives and make its work more focussed. However, since this would require treaty change, an interim step would be to appoint senior and junior commissioners in the new Commission in 2014.

The Hague has received support for its subsidiarity review from Germany, Sweden, Finland and Austria, some of whom are considering similar exercises. Even the president of the European Parliament, Martin Schulz, has said subsidiarity should be strengthened. David Cameron should make common cause with the Dutch and other reform minded member-states to toughen the enforcement of subsidiarity, which will not require major treaty change. But if the British prime minister misreads his potential allies and pushes for opt-outs or a large-scale repatriation of powers, he is certain to find himself isolated.

Rem Korteweg
Senior research fellow, CER

CER in the press

Financial Times
17th July 2013
"The UK would do even better to deepen its co-operation with the Schengen area, especially on visas," said Hugo Brady of the **CER**.

Prospect
15th July 2013
This year's international affairs think-tank of the year award goes to the **Centre for European Reform**. ...This year, the judges were impressed by the strength of the **CER**'s economic analysis and its choice of subjects has gone right to the heart of the most pressing debates, not least concerning Britain's relationship with the EU and the costs of leaving.

The New York Times
3rd July2013
"Portugal was one of the poster children for it [austerity], with a government that sounded even more wedded to austerity and supply-side reforms than the policy-makers sitting in Brussels, Berlin and Frankfurt," said Simon Tilford of the **CER**.

BBC News
26th June 2013
John Springford of the **CER**, said the eurozone was facing "very large political roadblocks" hampering the necessary macro-economic changes. "They are stumbling towards integration very slowly - when the financial markets relax the pressure, the progress stalls."

Financial Times
24th June 2013
As an excellent, if depressing, forthcoming paper from Stephen Tindale of the **CER** makes clear not a single one of the CCS plants which are supposed to be built in Europe by 2015 are actually under construction.

Reuters
17th June 2013
"Countries remain scared to pool [defence] capabilities because they don't want to lose control and they don't like the idea of having to sacrifice jobs," said Clara O'Donnell of the **CER**.

Der Spiegel
12th June 2013
"The more Erdogan develops into a kind of Putin light, the harder it will become to lobby for Turkish accession to the EU," says Charles Grant, director of the **CER**.

The New York Times
10th June 2013
"Apart from a very few countries, such as France and Britain, the Europeans have been very complacent about strategic affairs," said Rem Korteweg of the **CER**.

Recent events

Enrico Letta

17 June
Roundtable on 'The future of Italy and its place in Europe', London
With Enrico Letta, Italian prime minister

25 June
The CER won 'UK international affairs think-tank of the year' at the Prospect think-tank awards for 2013, London

Ed Balls

18 June
Dinner on 'Europe's growth problem and what it means for Britain', London
With The Rt Hon Ed Balls MP, shadow chancellor

10 June
CER 15th birthday reception, hosted by HE Georg Boomgaarden, Ambassador of Germany to the UK, London
With a keynote speech by The Rt Hon Ed Miliband MP, leader of the opposition

Ed Miliband

Martin Wolf and Charles Grant

5 June
Launch of the CER's commission on the UK and the single market, London
With Sir Brian Bender and Martin Wolf

10 June
CER 15th birthday reception, hosted by Ambassador Rory Montgomery, Permanent Representative of Ireland to the EU, Brussels
With a keynote speech by Radek Sikorski, Polish foreign minister

Radek Sikorski

For further information please visit
www.cer.org.uk