An EU "fit for purpose" in the global age

The EU in a world in transition: Fit for what purpose?

Edited by Loukas Tsoukalis

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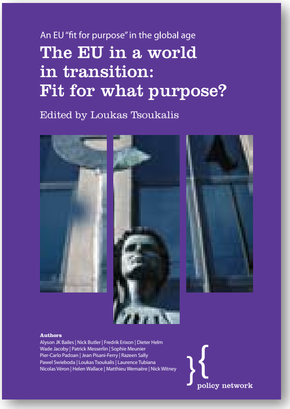

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About the project

Organised by Policy Network, in partnership with the European Institute of the London School of Economics and ELIAMEP (Hellenic Foundation for European and Foreign Policy), the EU "fit for purpose" project was initiated in May 2008 when Professor Loukas Tsoukalis presented to a workshop in London a substantial critique of the challenges and choices facing the EU in the 21st century.

Subsequently, a programme of study and events, co-directed by Olaf Cramme, Maurice Fraser, Roger Liddle and Loukas Tsoukalis, was organised around the central theme of this initiative: what the role of the European Union is as a political entity in a rapidly changing world and how it should reform itself, both internally and externally, in order to overcome and respond to the multifaceted challenges of the global age we now live in.

Over a period of 12 months, the project has sought to engage with a wide-ranging group of distinguished academics, policymakers and government advisers from across Europe, looking at the key clusters of policy choices facing the EU post-2009. High-level symposia and public events took place in Hydra, Paris and London.

Three publications mark the climax of this project:

- Rescuing the European project: EU legitimacy, governance and security *(edited by Olaf Cramme)*
- The EU in a world in transition: Fit for what purpose? *(edited by Loukas Tsoukalis)*
- After the crisis: A new socio-economic settlement for the EU *(edited by Roger Liddle)*

In addition, a synthesis report provides a compact analysis of how the EU needs to evolve and operate if it is to live up to the expectations and hopes of many of its citizens.

All of the publications are available in hard copy and online. Further information about the project and the organisers is available at:

Policy Network	*www.policy-network.net*
European Institute at the LSE	*www.lse.ac.uk/europeaninstitute*
ELIAMEP	*www.eliamep.gr*

Acknowledgements

The volume in hand is the outcome of an ambitious project. For those of us directly involved, it was a rich and worthwhile experience and I sincerely hope that it will provide a valuable input to the ongoing debate on the future of Europe.

Thanks are due to all contributors to this volume for the high quality of their papers and their cooperation. My thanks also go to Olaf Cramme, Maurice Fraser and Roger Liddle, co-organisers of this project. Our collaboration was smooth, enjoyable and, I believe, also highly productive. The team at Policy Network were extremely efficient: they had the main responsibility for the running of the project and the publications that came out of it. They did a very good job, and I am thankful for it.

I would also like to thank my collaborators at the Hellenic Foundation for European and Foreign Policy (ELIAMEP). Special thanks are due to Elizabeth Fokas and Matina Meintani.

We were pioneers more than fifteen years ago in changing the name of our thinktank to reflect a difference of substance between European and foreign policy. It was also meant as a statement. Developments since then have not proved us wrong. I trust the future will further confirm this distinction as Europe matures as a political entity.

Loukas Tsoukalis
Athens, October 2009

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Chapter 1

In a changing world where size matters

Loukas Tsoukalis

European integration started as an inward-looking venture: the fathers of Europe (there were no mothers at the time) began, in the wake of the destruction caused by the Second World War, by laying the foundations for peace and reconciliation in a new union. Global order was taken as a given and shaped by external actors. As progress ensued, greater prosperity, through the elimination of economic borders, became a key objective, soon to be joined by democracy as new members with fragile institutions and troubled political records later joined in. Thus, over time, Europeanisation acquired a much broader dimension.

The role of Europe as an external actor began with trade; it was part and parcel of the customs union. It gradually extended to other areas of policy, reaching all the way, albeit timidly, to traditional foreign policy and defence. The legal and institutional basis for EU external policy varies considerably from one area to the other, and coordination of different policies and instruments leaves much to be desired. True, there has been a great deal of the so-called spill over, but the experience of trade has proved difficult to transplant to other areas of policy. As an international actor, the EU is still less than the sum of its parts. It is not a power in the traditional sense of the term, nor is it, of course, a typical international organisation. Rather, it continues to defy classification, a trait that can serve as one of its many attractions, as long as it is able to deliver.

Europe has developed a comparative advantage in different forms of soft power, through trade and aid, as well as its support for multilateralism and the defence of global public goods, such as the climate. Civilian power was the term coined for Europe many years back; normative power is another term used now to denote an emphasis on values and rules rather than interests narrowly defined. The EU constitutes in itself an attempt to move away from the old world of power politics.

There is, however, another less benign reading of Europe's collective role in the world. Europeans are trying to make virtue out of necessity, old style realists would argue. Europe continues to depend on the security umbrella of the United States provided through NATO. Many European countries are at best thinking of a European role in global affairs on the model of Switzerland writ large. And there are those who confuse soft power with talking power. Indeed, Europe does a great deal of talking, often as a substitute for policy. Arguably, only the big countries are capable of thinking globally and strategically – and they do not always think European.

Both descriptions are true: the description of Europe as a different kind of power offering an alternative model of governance in the global age, and also that of a still divided and often powerless entity resembling an NGO in a world where power politics (and martial arts) remains a popular game. Both descriptions contain elements of truth in a complex and increasingly interdependent world. They are not mutually exclusive. In fact, they should not be treated as such by those who aspire to greater European influence in a rapidly changing world.

What has changed?

History books may decide that the period of American hegemony, following the collapse of the bipolar system established during the cold war, was in fact remarkably short. As China and the other emerging powers begin to flex their political muscles, the United States, still more equal than others, is being forced to negotiate its way with other countries. Thus, power is becoming more diffuse in an increasingly multi-polar world. At the same time, the world is still very unstable, with unresolved conflicts, failed states, nuclear proliferation, messianic ideologies, terrorism and organised crime, abject poverty and new waves of international migration, fierce competition for access to raw materials and a time bomb ticking under the name of global warming. On top of this worryingly long list of challenges, history also tells us that the transition from one political order to the next is rarely peaceful.

If anything, the economic crisis has reinforced the trend towards multipolarity. China and others have become indispensable partners in attempting to manage a crisis, the scale of which had not been seen since the Great Depression, a crisis that was made in the west and quickly turned global. It surely marks the end of an era. The globalisation model that relied on the liberalisation of financial markets to spearhead global economic integration is itself in deep crisis. Protectionism is on the rise together with rates of unemployment. International coordination has so far averted the worst case scenarios. But looking beyond the crisis, many people now realise that a global economy requires new forms of global governance and effective international institutions.

In this rapidly changing world, Europe no longer occupies centre stage. Power has gravitated elsewhere, and mainly eastwards. The relative weight of individual European countries, measured in terms of population, income and trade, has been steadily declining for more than two decades; it can only go further down in the foreseeable future. On their own, European countries no longer count for much in the company of big powers, and they will count even less tomorrow. This is a hard reality to reconcile oneself with, especially when it concerns the old great powers of Europe.

In the next few years, the key challenge for Europeans will be to identify and collectively defend common interests and values in a world where size still matters a great deal. They have a model, at least a collective experience, worth exporting to the rest of the world in search of new ways of managing global interdependence. As for their immediate neighbourhood, it includes several countries where poverty and instability combine for an explosive mix: a different kind of challenge for Europe as a regional power.

Will unity prevail over diversity? The answer will surely vary from one policy area to the other, even from one case to the next. But we should be under no illusion. Lack of unity usually comes with a price tag: a divided, ageing and shrinking Europe courts with strategic irrelevance and decline.

Can European security and defence policy go beyond a collection of haphazard peacekeeping missions? And if so, what kind of place will be reserved for the big countries – at least those ready to invest in a common

European defence effort? Pooling resources in the defence industry, adjusting military capabilities to the new security threats and deploying more troops in joint operations abroad would be a good way to start.

Europeans will need to address politically awkward (and often divisive) questions, including Europe's relations with the big powers; most important of all being how it moves forward with the United States. Relations with Washington still go through London, Paris, Stockholm, Athens and Riga rather than Brussels. The Obama Administration may be ready for a strong and reliable European partner (not partners). But how many Europeans are ready for it? Illusions of different kinds of special relationships die hard, as do old habits of free riding. Admittedly, eastern enlargement has complicated matters further.

In order to collectively defend common interests and values, investment must be made in European unity, by way of money and institutions. Intergovernmental cooperation on its own can only deliver so much: we should have learned something from the experience of Europe's common foreign and security policy, with or without defence. There are political choices to be made with respect to common instruments and policies, as well as methods of reaching decisions internally and ways of being represented internationally. There is also the possibility of opt-out, even temporarily.

The new Treaty of Lisbon creates the conditions for a more effective European presence on the international scene. After all, this has been one of its main *raison d'être,* though poorly communicated to those directly concerned, namely Europe's citizens. Lisbon is far from perfect; and it is only a framework. But this is what treaties are for. The contents of policies can only be decided later, and of course much will depend on those who will occupy the new posts created by the treaty, most notably the President of the Council and the High Representative, in cooperation with the President of the European Commission.

Limitations of a regional power

Foreign policy begins with the neighbours, and Europe's neighbourhood is mostly poor and unstable. Successive rounds of enlargement have been the most effective foreign policy of the EU. They have helped to export *Pax Europaea* to an increasing number of countries on the continent and they have also acted as a convergence machine for the economic periphery of Europe. This is a record to be proud of.

The big bang enlargement of 2004 and 2007, with the accession of twelve new members, has been the most daring, and also the most difficult. Successful transitions to democracy and the market are now going through a harsh test in some of the new members hit hard by the economic crisis. European solidarity is also being tested in the process.

At present, the appetite for further enlargement is limited: arguably, a sign of indigestion, which is certainly not helped by the economic downturn. Many people believe that the criteria for accession have been applied loosely in some cases. A strict application of those criteria in the future, coupled with a manifest lack of enthusiasm for further enlargement at least in some members, will mean that most countries of the western Balkans as well as Turkey, not to mention possible future candidates, including Ukraine and Georgia, will have to exercise their patience in the waiting room for several years to come.

The process of further enlargement will be long – it also appears to be highly unpredictable. It will require strategic decisions, which the EU is not always best equipped to take. Hiding behind the technical aspects of the *acquis* is politically more convenient; it is also a much more natural reaction for bureaucrats. On the other hand, enlargement raises uncomfortable questions about internal cohesion, identity and borders, not to mention the budget and institutions. They are uncomfortable questions precisely because there is no agreement as to the answers to be given. Not surprisingly, many people try to avoid them. Yet, whether we like it or not, enlargement has become politicised, and there is no way back.

We know that all previous attempts to offer substitutes for full membership have not convinced any of the candidates. It is unlikely to be any different in the future. But if further enlargement proves to be a long drawn process at best, the EU will be forced to devise intermediate stages, and link them with concrete benefits, for countries in the waiting room. We need to do much more in this area, starting with visas and measures affecting the younger generations.

The emphasis on the adoption of EU regulations, as a pre-condition for improved access to the European internal market, inevitably carries with it an economic cost for countries with lower levels of development. This applies to other associated countries with no prospect of membership, only more so. Exporting rules and regulations to neighbours and others is not always cost-free. It also sometimes verges on the surreal when Brussels pretends that some (privileged?) partners have either the political will or the institutional capacity to apply some of those rules and regulations. Going beyond the technical or the strictly economic, do we honestly believe there are many "shared values" between Europe and various kinds of authoritarian regimes in the neighbourhood? And how far are we prepared to push "conditionality" in our relations with countries that may not be candidates for membership in the near or even distant future?

The EU often behaves as a regional power with global rhetoric. Its neighbourhood is highly diverse: a common policy applying to all countries should recognise this diversity, and hence allow for much needed flexibility in relations with individual countries. The Union for the Mediterranean and the new Eastern Partnership are recent attempts to revitalise neighbourhood policies addressed to the south and to the east. The EU would prefer a multilateral approach. Geopolitical realities though are likely to impose their own logic and limitations. Rhetoric sometimes runs out of control. There is a big risk that the gap between ambition and delivery will once again be uncomfortably wide. In the meantime, it would help if the EU were to make better use of its economic aid to neighbours and more distant partners in the developing world.

European soft power has repeatedly hit against the hard rock of power politics in relations with the neighbours. The EU now has a shared neighbourhood with Russia; it should not necessarily be treated as a zero-sum game. And how does post-modern Europe deal with post-imperial Russia? Does a common European foreign policy precede a common energy policy? In relation to Russia, the European answer so far seems to be neither. What kind of incentives should be offered to Germany (and others) in order to persuade it to integrate its bilateral relation with Russia within a common European policy? Preaching will simply not do. And what kind of assurances should be given to the new members who bring with them a long and painful experience of what virtual sovereignty feels like? A package deal should not be beyond the capacity of European institutions and politicians. Europe needs to handle more seriously, and in a more united fashion, its relations with the big neighbour to the east: it will be a real test of Europe's power in the making.

On the other hand, turning the Mediterranean into an area of peace and prosperity depends crucially on the resolution of the Israeli-Palestinian conflict. The EU has for long been reduced to the status of a frustrated observer, making the odd token gestures, hoping that the United States will drive the two sides towards a peaceful settlement, even when it was blatantly obvious they were driving in the wrong direction, while the carnage went on in the Middle East and the Europeans paid for the buildings that were repeatedly destroyed and rebuilt. Europe is directly affected in many different ways. After all, it is all happening in its immediate neighbourhood. Europeans tend to underestimate the policy instruments at their disposal, including those that come under the category of soft power, perhaps because they are afraid of dirtying their hands and taking risks. Such may be the limitations of a timid (and often divided) civilian power. But those limitations come with a big price.

Exporting a model

Trade policy, financial services, energy and climate change are four areas in which the role of the EU will be crucial in the years to come. They combine the old and the new as Europe's fields of competence go on expanding, often in response to a rapidly changing external environment. These are all policy areas in which European soft power has a concrete meaning; and it is more familiar ground for European collective action.

The EU is already big and influential in trade matters. Influence is indeed commensurate with its size, being the biggest trading bloc in the world. The Commission negotiates on behalf of the Union on the basis of mandates agreed by the Council through qualified majority voting. Material conditions differ widely inside the Union and so do political preferences on national or ideological grounds. Yet, the European legal and institutional system succeeds in delivering common positions in international trade negotiations, admittedly through intense bargaining and complex package deals, which are the trademark of the EU.

Liberal principles are not easy to reconcile with domestic interests and pressures, from agriculture all the way to shoes, cars and financial services. In times of economic crisis, with unemployment rising and national governments spending large amounts of money to save financial institutions and other lesser mortals from bankruptcy, the task will become exceedingly difficult. It will not only affect European trade policy vis-à-vis the rest of the world: the survival of the internal market will also be at stake. Preserving a liberal stance and avoiding beggar-thy-neighbour policies will require political courage and strong coordination at EU level. More effective compensation measures internally for the losers would also help.

Europe has been an advocate for multilateral management and rules for the international trading system, albeit not always in a consistent manner. For a long time, the EU tried a difficult balancing act between multilateralism and preferences. In more recent years, it has been tempted back to negotiating bilateral agreements, albeit with unspectacular results. In order to be able to lead, if anything by example, in a world trading system in which power becomes more diffuse, the EU needs to be seen as complying with existing rules, including decisions that go against it in the dispute settlement procedures of the WTO, which itself has played a key role in setting up.

The EU has repeatedly tried to promote regional integration in other parts of the world, albeit with limited success. It should perhaps recognise the limitations of this approach, at least for the time being. On the other hand, Europe still runs a fragmented trade policy: EU competencies remain limited in the so-called new areas, including most notably services. Such fragmentation does not help Europe's negotiating stance in international forums, and it is high time that we try to glue the different pieces together.

The trade deficit with China is dangerously large in times of rising protectionism. Should Europeans follow the US example of directly linking this trade deficit to currency manipulation by China? In any case, they should avoid speaking with 27 different voices, and thus risk not being heard at all in the vast land of this rapidly emerging Asian power.

The illusions held by so many people for so long concerning the efficiency and self-regulating capacity of financial markets have come crashing down, causing a real disaster for the global economy in the process. The need for new standards, more effective financial supervision and global economic governance more generally are now almost universally recognised, although the devil surely lies in the specifics. And we are only at the beginning. For a globally integrated market, nothing short of global solutions will make much sense. The credibility of the United States and the west more generally has suffered a big blow. Emerging economic powers will have a much greater say in the setting up of the new order. And free riding, through regulatory or tax havens, has at long last reached the top of the international agenda.

Europe is a major player in the negotiation for a new global financial architecture, sometimes represented through the big countries, sometimes through the eurozone, and less so through the common institutions of EU27. A European common front makes a real difference in those negotiations. The form of external representation in turn largely depends on what happens internally. The crisis is most likely to act as a major catalyst for further integration in Europe: the economic governance of the eurozone and common financial regulation are prime candidates.

Will attempts at strengthening global economic governance concentrate on existing financial institutions, albeit reformed, or will they instead be canalised through more loose intergovernmental structures along the lines of a revamped G20? Whichever direction we go (probably both), the IMF seems to have been resurrected from the dead with an important mission in times of crisis and thereafter. A real reform of the IMF, unlike what was achieved last time round, can only go hand in hand with a major redistribution of power in its governance structure.

Europe has been a keen supporter of strong international institutions and common rules, trying to project its own positive experience to the global level. Europe is also grossly over-represented on the IMF executive board, as it is also at the World Bank equivalent as well as in other international organisations. Those calling for a single representation of EU countries, or perhaps more realistically the eurozone, coupled with a substantial reduction of the overall European weight of votes in those two financial institutions, have been steadily growing in number. Such a move would have a strong symbolic value, while also providing an effective lever for the reform of international financial institutions. Is Europe ready to turn rhetoric into action, or not yet?

Dealing with new challenges

Energy is not new on the European agenda, although the record of concrete achievements remains feeble. Coal went quickly into decline in the founding countries, while nuclear energy never took off as a collective European project.

The EU is highly dependent on imported energy, especially oil and gas. This dependence will grow further in the future. It certainly does not help that the main suppliers are Russia and countries in the Middle East. On the other hand, import dependencies vary significantly from one member country to the other, and so does the energy mix, including the role of nuclear energy, in each country. There is as yet no European market for energy: just a juxtaposition of national markets with different forms of state intervention and limited links with them.

Pure market solutions in the energy sector are a dangerous illusion, and so are independent national solutions. Energy is a prime example of how Europe could make a real difference combining the depth of a large internal market, solidarity among members and strong negotiating power vis-à-vis foreign suppliers. True, it is not an easily achievable target: it requires careful and patient building of a complex package deal.

We are not there yet. The Commission has been pursuing a policy of "unbundling" in electricity and gas, as a way of strengthening competition and creating a true European market for energy. This policy remains controversial. Do we instead need large companies in an inherently oligopolistic market, in which so much of the production is in the hands of large state controlled companies? And would the establishment of European grids in electricity and gas be a surer and more direct way of creating an integrated market?

Energy policy is inextricably linked with high politics: the European component has been until now weak in both. The stakes are high and member countries have been reluctant to entrust the Commission with representing their interests in the context of a common European policy. Oil and gas pipelines have tended to divide European countries. Russia has been only too keen to exploit those divisions, while US pressures have not always helped much either. Strategic reserves and mutual support among members will have to be key elements of a common European energy policy. And so should greater energy efficiency, coupled with diversification of supply sources and a more realistic policy vis-à-vis Russia.

Energy is directly linked to climate change. Europe is turning "green"; at least, it is aspiring to. And it has also become a world leader in the fight against climate change, consistent with its ambition to act as a normative power defending global public goods. With the early adoption of post-Kyoto targets, Europe is trying to lead by example and thus helping to shape the international agenda.

Scientific opinion suggests that this is the biggest threat facing mankind. We are told that dealing with it will require a radical shift in production and consumption patterns. Few as yet are ready for it. The economic crisis could provide the opportunity to think out of the box. Alas, for the majority of policymakers climate change action risks being seen as an unaffordable luxury in times of hardship. Will carbon taxes help to alleviate the cost? And are they likely to serve as an excuse for protectionism?

There are big costs involved – and the politics of distributing those costs within member countries and within the EU is both difficult and painful. The negotiation on the Climate Energy Package provides a clear illustration. Intra-European negotiations require consensus, which in turn raises the risk of agreements being reached on the basis of the lowest common denominator. The shift from coal to gas in some of the new members also raises awkward questions and trade-offs between security of supply and clean energy: one among several difficult trade-offs facing policymakers.

Are the targets achievable? The 20:20:20 targets agreed by the EU for global emissions reduction, the share of renewable sources and energy efficiency improvements by 2020 may be good as a sound bite. Many people doubt whether they are realistic. It would not be the first time that rhetoric runs ahead of the capacity to deliver. Even if achievable, already a highly optimistic assumption, will the targets be enough to deal with the problem? Scientific predictions about the effects of global warming are only getting worse: the stakes will be higher. And what will Europe do, if other countries, with a large share of carbon emissions, do not follow suit with ambitious and binding targets? Hopefully, we will know better after the Copenhagen conference in December 2009: a very important, though surely not the final, stage of a long, difficult and pretty unusual process of international negotiation.

Soft and hard power

The global age has been forcing the European Union to turn increasingly outwards. Meanwhile, the economic and financial crisis has added a greater sense of urgency to this task. Defending common interests and values, as well as drawing lessons from its own successful experience in the search for new forms of global governance, could provide Europe with a mission in a rapidly changing and highly unstable world. There are difficult choices to be made and bargains to be struck. There are also lessons to be learned from past experience.

Soft, and (why not?) smart power remain the privileged domain of collective European action. This is entirely consistent with the internal logic of European integration. Trade, finance, energy and climate change are prominent examples. But action does not often match the rhetoric.

European hard power follows a long way behind. As defence merges increasingly with security, many Europeans are still reluctant to invest in European unity in this sensitive area. Some even think that the European is somehow incompatible with the Atlantic. The learning process is taking a long time: arguably, too long.

The coming of age for Europe as an effective global power will require strong political leadership coupled with a vision of Europe's place in a new world order. Both have been in short supply in recent years. The most powerful driving force may indeed prove to be a negative one, namely the fear of being marginalised in a world in which power becomes more diffuse but still very much unequally distributed.

Chapter 2

External security policies and the European model

Alyson JK Bailes

"Europe's role in the world" rolls nicely off the tongue, but is actually a highly complex and ambivalent notion. It includes actions taken by European states nationally, through NATO, and in other Europe-based institutions such as OSCE. It covers the impact of non-state actors ranging from large European firms to Médecins sans frontières, OXFAM or the BBC, and the global spread of European-born languages and religions. These other influences may be equally powerful with – and by others confused with – any difference the European Union makes as an institution.

The Union's role, in turn, has at least three dimensions relevant to global security. One is the impact of its internal policy creations – the world role of the euro, common trade and structural policies, border and migration control – and the direct spreading of these through enlargement. The second consists of externally-directed policies and actions largely gathered in the "second pillar": Common Foreign and Security Policy (CFSP), European Security and Defence Policy (ESDP)[1] but also Commission-administered development and humanitarian aid. The third is the EU's existential impact on the world order, made up of its input to global regulation, its place in the multi-polar balance and any "model" effect on regionalising processes in other areas.

Trade, aid, enlargement, internal security policies and other globally important functional policies (e.g. on energy and climate change) are dealt with elsewhere in this collection. The present chapter will focus on – for want of a better term – the second-pillar instruments, but ends with a word on the EU's existential effects.

EU limitations – not all self-inflicted

As of the early 21st century, the EU consciously limits its security footprint in three main ways. First, it has not become a fully guaranteed self-defence alliance (as proposed in the failed European Defence Community of the Fifties), but limits its military efforts to "crisis management" – using a definition borrowed from the defunct Western European Union.[2] Second, its philosophy for using military means abroad is essentially altruistic: geared to "peace missions" (though rescue missions for EU citizens are possible), and respecting the framework of international law. And third, it manages CFSP and ESDP in inter-governmental style, with minimal common finance and no troops or equipment under permanent joint command. This makes it hard to combine military and diplomatic actions closely with the use of the Union's far larger "core" resources in the first pillar, or even with third pillar (anti-crime, anti-terrorism, border management) instruments. Implementing the Lisbon Treaty would merge the Council's and Commission's external services, and give more room for personal leadership by the European Council President and Solana's successor, but would do much less to solve the cross-pillar problem.

These limitations are not all of the EU's own making. They reflect constraints like the prerogatives of NATO, and the reluctance of most Europeans even now to brand the Atlantic strategic link as moribund. Keeping ultimate national sovereignty in defence and security makes sense not just for reasons of constitutional principle, but because European states have major differences in strategic outlook deriving from geography, history and internal governance. Even the spectrum of newer non-military threats hits northern and southern, eastern and western members in different combinations and degrees. The "soft" altruistic agenda, whereby CFSP and ESDP can be used to express "the best of Europe", has thus imposed itself as the only one easily acceptable to all 27 members, now including six non-allies.

The deeper truth is that Europe at this stage in history has neither the will nor ability to become a self-sufficient and globally competitive military power. Its psychological outlook and values are *post-colonial, post-fascist* and *post-communist* – on all counts shrinking from the "might is right" philosophy, from forceful imposition of ideologies and from re-assuming imperial-style burdens. Even its more forthright military performers, like the UK and France, are also caught by the limitation of a *post-modern* economic structure – globalised, interdependent, built on "confidence" as much as fixed assets – that does not allow either really large defence budgets, or the alienation of *any* big partner. Finally, European democracy and media alertness impose some limits on governmental uses of force – though in shadier areas like arms sales and private military companies, Europeans can and do behave with much less restraint.

The mysterious lightness of "interests"

The European Security Strategy (ESS) of December 2003 is the closest Europe has got to a global mission statement.[3] Typically, it dodges using the language of a European self-*interest* distinct from others' needs and aims in the world. In fact the only paragraph using the word "interest" urges the EU to "take a stronger and more active interest in the problems of the southern Caucasus" to avoid enlargement creating new dividing lines. EU "interest" did nothing to stop Georgia and Russia going to war with each other in August 2008, and the effect has been at least temporarily to make sure the enlargement boundary stops well short of Tbilisi.

The ESS has a lot to say about those issues that plainly put all Europeans in the same boat, notably the quest for a world of "effective multilateralism" that will play to the European model's strengths rather than weaknesses. But it is silent – and other EU documents are at best wishy-washy – on the largest strategic issues that still divide and baffle Europeans themselves. Is the US still trustworthy enough, and how long will it be strong enough, to justify staking all European hopes of physical protection on its alliance? Is a "nicer" US, now emphatically on offer with President Obama, liable to be a blessing in disguise since it competes with the EU's respectable image and further reduces the likelihood of Washington taking major risks for European lives? Are NATO's territorial guarantees still credible, do Europeans still need them and is there any substitute? How to live with a Russia that is going to be nasty for some time, without making it lash out further? Can Russia and its neighbours ever be helped to realise their own European vocation? What kind of China does Europe want and how could it influence what China becomes? How long can Europe afford to lavish more military missions and aid on Africa than on the Middle East or other parts of west/central Asia that are not only geographically closer, but more vital for its own borders and supplies? Overall, is it better for Europe to dabble in all world regions to show its global ambitions and values, or to focus its limited resources on a few places/issues – and which?

Lacking a clear answer to such questions Europeans can hardly make a logical judgement on how proactive the EU needs to be externally, as distinct from cultivating its own garden, and on how to balance effort between traditional "security" and asserting European interests in other fields like economic governance. Likewise, Europe can neither reasonably assess whether enlargement should be driven at all by strategic considerations, nor what level of resources is actually sufficient.

Thinkers who want the EU to become a more self-conscious "power", and those who want it to serve unselfish "human security" goals, both tend to conclude that more is needed – of everything. Since that "more" can only come from nations, this is to say that all EU members must either re-direct resources towards the military and other security tools (recession or no recession!); or that they must pool more resources centrally for collective policies that are often wider and bolder than their own traditions; or preferably both. In political terms, at least outside the circle of ESDP buffs and defence industry associations, these are proposals of staggering significance and difficulty. Since NATO tried to achieve the same things for sixty years, for fifty of which it was helped by a massive direct military threat, with pitifully little success one must ask why the EU should think it can do better.

What follows in this chapter reviews the EU's actual instruments and policies, coming to the ESDP last. In doing so, it will go beyond the usual questions about their fitness for purpose to ask if we know what the purpose is. If not, how if at all could the gap be filled?

Security building and "restraint" instruments

The bread and butter of EU collective diplomacy remains the creation of common and coordinated positions in CFSP. The type of work done has not changed radically since the 1970s, so that EU coordination within larger organisations, efforts for generic arms control, regional security concepts, crisis mediation and regional dialogues still account for most of the output. True, joint actions can now be adopted that have centrally-managed funds behind them, but on a tiny scale compared with internal budget spending. The Brussels staffs are starved both of numbers and competence by wary nations.

Before proceeding to the customary ridicule of this situation it is worth noting that it suits most capitals well. Brussels diplomacy does not make serious inroads on the national version but can both magnify and de-conflict nations' efforts when there is a potential common cause – as there usually is in these relatively non-controversial fields. More subtly, the EU collectively still follows the methods and proprieties of conventional “diplomacy”, and is unlikely to compete by applying any more “new-age” global techniques even when and if Lisbon strengthens its central staffs.

At the least, this situation more or less ensures leading European states will not back different sides in a violent dispute, as they did so often to the world’s cost in the past. And many of the EU positions on international law and order that were branded as wet and naïve by the neo-cons since 2002 look a good deal more statesmanlike in the light of recent US failures. Even before Bush’s departure the US was using “European”-type methods to contain some of its toughest problems (vide the WMD stories of Libya, North Korea, India, and restraint over Burma and Georgia). On futures for Iraq and Afghanistan the US line is rapidly swinging back towards visions of containment via regional cooperation, and President Obama is emulating EU tactics in talking to Iran. So one should hesitate to brand EU declarative diplomacy as wrong-headed *per se:* the problems are more ones of coverage, and of course of leverage and follow-through.

As noted, many gaps in CFSP’s development are linked with the existence of NATO, and arguably also the UNSC, G7/8, and now G20 and IMF, as preferred channels for strategic interface with the US and other top powers. The “bad cop-good cop” duality with NATO suits the EU in risk limitation terms, as seen in the recent Georgia crisis. Tough as it was for European leaders to mediate with Moscow while holding the 27 together, the EU’s policymaking would have been much harder if it had also had the option of military action. The problem is that NATO’s credibility both as a common defence organisation, and as a prudent manager of strategic coexistence with Russia, has been on the slide under the two Bush Administrations: as seen in the neglect of détente and arms control, egregious provocations like central European missile bases, and lack of answers when faced with a real challenge like Georgia. NATO’s enlargement beyond the western Balkans now looks even more problematic than the EU’s.

Under President Obama NATO shows some signs of finding its way back to prudent and balanced policies in Europe, and it is in Europeans’ basic interest to see it gets what extra lease of life it can. Even the briefest speculation on how Europe would survive without a US guarantee reveals alternatives of massive militarisation, reliance on an Anglo-French nuclear trip-wire, collective neutralisation, or bargains made as a junior partner with Russia (China?) that put the worst strains of trans-Atlantic cohabitation in the shade. More subtle have been the tactics of French President Sarkozy, who was confident enough to normalise French relations with NATO in 2009 perhaps precisely because he now stands taller there alongside a chastened US, underperforming Germany and intellectually absent Britain. It is right to have some hopes of calmer NATO-ESDP relations as a result: but will it not also become easier to pull together both institutions' European assets independently, under strong French leadership of course, if a more open shift by Washington towards limited liability should ever demand it in future??

Accepting that the EU neither wants to grab this primary strategic mantle nor will be forced to accept it soon, its power relations with the US, Russia and China will remain driven for some time by trade, finance, border management and other non-military security issues. To say this is neither to belittle European responsibilities nor to abandon ambition. The 2008-9 crisis is testing Europe's ability to play a tough and united hand in global economic governance, and it is too soon to say the test has been failed. Internal dynamics are leading the EU organs to make greater, better-coordinated efforts in fields of civil protection and functional security – boat people, bird flu, cyber-defence etc etc – at the same time as Obama's America is signalling a less militarised approach to "new threats", so that this agenda could join climate change policy as a field for stronger *and more equal* Atlantic consensus. Opinion polls show intriguing signs of concern about non-state threats rising in countries like Germany, Spain and Italy towards the UK and French levels,[4] and this is one field in which Britain has shown some understanding of its need for neighbours' solidarity.

Such issues may also provide constructive ballast in relations with Moscow; but whether Russia can ever really respect – let alone learn from – the EU has much more to do with energy (not discussed here) and enlargement. Here the EU seems to be slowly grasping that the central European experience, where the candidates themselves took on the heavy lifting of local peace-building and internal transformation before entry, will never happen again. The western Balkans cannot make the grade without a period of EU strategic, even military, tutelage. Former Soviet states cannot peacefully enter an EU zone of peace without major change on all sides of the triangle of attitudes between themselves, Moscow and Brussels. What then is the EU's motivation to make the larger investments and take the larger – and potentially divisive – risks that eastward expansion demands? In terms of real long-term self-interest and strategic destiny, is it more important to build Europe through the Caspian steppes and Caucasus towards an ultimate frontier with China, or would it make more sense to invest effort in Turkey as the gateway to the geographical "arc of crisis" and spiritual Muslim world? Either way, what is the logic of exerting the smallest integrative effort and least strategic imagination of all towards the near east and north Africa, where the potential for large-scale conflict, massive migration, and all kinds of non-military security disasters is perhaps the greatest around the whole EU periphery?

For the moment, the short answer is that the EU lacks will and energy to make enlargement work in any of these directions except, slowly, the Balkans. But in that case it needs better fill-gap policies than any "neighbourhood" concept produced thus far – though the post-Georgia recension does show welcome realism about candidates' own weaknesses. And if European boundaries have ended one spell of rapid advance, the means of stabilising and defending them should be looked at again more seriously, including the possible blending of civil, para-military and even military tools to deal with migration surges.

Instruments of intervention

Despite all the hype, the question of active ESDP interventions with military and/or other assets is a rather limited sub-set of these issues.[5] Towards the strategic actors currently most fateful for Europe - the US and Russia – the functionality of ESDP is at best political and indirect. Washington may now be more ready to greet EU interventions that go where NATO can't for political reasons (Lebanon, Palestinian territories) or for functional reasons (non-military missions), and may mildly applaud a show of global responsibility by European forces in Aceh or Chad. But none of this will change its mind on whether or not to attack Iran, or indeed to defend Poland. Russia is more likely to tolerate EU actions in post-Soviet territory as a lesser evil compared with NATO or direct US intervention, and on the assumption that EU troops will do anything to avoid confrontation with its own.

The alternative view that ESDP should anyway not work for European interests but serve "human security", has already been alluded to. But even if this were the real point, it is clear that military inputs as small as the EU's can only go a small way to resolving any weak or divided state's problems, and will help much less in the long run than EU money, models and (where possible) enlargement. Anyway, the pattern of ESDP actions has not in fact yet shown a dominant "human security" logic or Europeans would now be dying for Darfur or the Tamils.[6] Aside from the big Balkans-related missions it has been opportunistic and experimental and, many would now say, has arguably achieved less by spreading its efforts around *without tackling the basic issues of European capabilities and motivation.*

Recent studies have laid bare ESDP's failures to boost European nations' deployable military output or even equalise quality standards.[7] Of the EU countries' approximately 2 million force personnel only 3.7% were deployed abroad in 2007, with a few (larger and Nordic) countries carrying most of the burden. There are obstinate problems of "interoperability" and rapid reaction even in non-military operations, due *inter alia* to the differing traditions and general overstretch of Europe's internal security elites. If these shortfalls reflect weaknesses in enforcing agreed capacity goals from December 1999 onwards, including the effort spent on side-tracks like the EU Battle Groups, they can also be read as a failure of *motivation*. The Helsinki documents of 1999 defined *what* missions ESDP could conduct, but never came clean on *where* and *why*. With all the EU's values and strategies emphasising its civil and peaceful nature, and with no EU ownership of the *ultima ratio* of self-defence, where is the logic for the EU to be the strictest ever taskmaster in its members' militarisation? What mere "peace mission" could drive EU nations to boost efficiency with the kind of large multinational forces NATO once had, but dismantled after the Cold War? With the lessons of Iraq and Afghanistan bloodily fresh, who can now be sure that the first really tough mission launched by the EU will not be its first great disaster?

Solutions to get ESDP out of the doldrums are proposed all the time, but rarely convince. Some recent authors have suggested giving up on the under-performing states and encouraging the EU "bigs" to build an elite force pool, perhaps exploiting the idea of "permanent structured cooperation" (PSC) contained in the Lisbon Treaty.[8] This kind of concentration is happening anyway in the defence industry, and the European Defence Agency now has a chance of steering it towards catering for Europe's real and distinct operational needs. But on choosing missions abroad, big European states typically disagree more than small ones, and when they do agree they are self-sufficient enough to act with the UN, the US or ad hoc. The bonus for using the EU framework is broader European political and economic support – but why should small states give that if ESDP is redesigned on lines that belittle and reject their own inputs?

In principle, some states could concentrate instead on civilian/ humanitarian contributions - and NATO would be happy to see the EU support its own actions with such inputs. But taking key personnel out of

Europe for the purpose is less and less appealing as our own societies' vulnerabilities are highlighted. Maybe a more radical experiment with economic levers could help? It might be easier for the EU to have a common defence budget than a common army. Big central funds could help medium-sized countries raise more troops past the deployability threshold; help the smallest to fill niches; allow the truly reluctant to buy their way out of serving - and finance the hire of non-European or even private troops.[9]

Another way ahead could lie through intensifying cooperation, and improving civil-military burden sharing, in Europe's internal (or "non-military territorial" security). The "solidarity" declaration of March 2004 already allows military cooperation to deal with the aftermath of terrorist strikes or natural disasters at home. The idea is on the table – though without wide consensus yet – of joint paramilitary border forces or joint naval action against "boat people". Defending trade routes for *economic* self-interest has a history from back in the 1980s, when WEU coordinated European protection of shipping and de-mining actions in the Gulf. Could the operation launched in 2009 against Somalian pirates hint at a new direction for ESDP: one that links EU internal and external identities more organically than before?

Exploring new motivations that straddle the external-internal border also means, however, addressing the frontiers in Brussels. The Commission holds the purse-strings for most external expenditure even on high-policy issues like the security and disposal of WMD. Its emergency aid spending can dwarf the common costs of "hard" ESDP missions. While Council experts and academics sweat over philosophical formulations for the ESS, the Commission has financed massive studies on new technologies vital for Europe's long-term independence and competitiveness, and is busy pump-priming their development. Clichéd though it may sound, the fact is that the EU will remain hobbled and schizophrenic in its strategic development so long as some way is not found – and Lisbon would go only a part of that way – to combine these different institutions, services, dimensions and tools of EU security action in the service of a single European will.

The existential dimension

The reunification of Europe at the end of the Cold War, the enlargement process, and a single market of 500 million people make Europe a pole of power today in a way that it was not in 1950 or even 1989. As shown, however, it is not a "normal" power: because it is collective, it is multiwilled (not top-led like an old-style empire), and strategically it is the "softer" subset of a "hard" Atlantic defence community. Even if this last point gives way to a real EU defence policy, the other aspects of Europe's singularity will alter much more slowly. Thus, for the foreseeable future the EU's existence will both make the world more multi-centric, and simultaneously challenge the realist assumption that multi-polarity means a struggle of all against all. The EU does not seek to win a global contest; but it is not an easy subject for a global winner to bully and subjugate either. It exerts perhaps the most subtle constraints over the friends it works with most closely.

The peculiarity of this European model is that people either feel strongly driven to copy it, or do not see the point at all. National leaders who equate power with success and/or virtue – as Washington and Moscow normally do – are unlikely to grasp the moral and practical rationales of EU restraint. They are either annoyed by European diversity and "weakness", or drawn to exploit it. This is why the EU has little option but to behave towards them as much like a coherent single power as it can. It cannot in practice achieve "effective multilateralism" by appealing to NAFTA over the head of the US, or the Shanghai Cooperation Organization for China.

At the same time, longer-term EU self-interest dictates trying to boost the influence of other regional communities echoing its own approach, and to trigger regionalising processes where they are lacking – the most flagrant cases being on its own eastern and south-east borders. Sooner or later the Union must wake up to the fact that, when so many of its strategic problems as well as virtues stem from the uniqueness of its nature, its deepest interest lies in making others – and eventually, the world – more like itself.

Chapter 3

Global power or big Switzerland?

Nick Witney

These are unsettling times for European defence and security establishments. Institutionally, they hate change; after all, their whole point and purpose is to protect the status quo. But since the fall of the Berlin wall, now 20 years ago, they seem to have faced little else – with the global economic crisis only the latest cause for uncertainty. The Balkan wars of the 1990s were both reason and excuse to put off the profound reappraisal of defence and security in Europe for which the end of the Cold War called. But with the birth of the European Security and Defence Policy (ESDP) at St Malo in 1998, some new thinking began gradually to take hold; and over the last decade we have seen the slow emergence of a new orthodoxy, based on a number of important insights.[1]

The new orthodoxy

To begin with, the real post-cold war threats to Europe's citizens are such trans-national challenges as terrorism, nuclear proliferation, organised crime, regional conflict and state failure. Security, therefore, no longer lies in manning the ramparts and preparing to resist invasion. Rather, it requires the means to move out and tackle problems at source – to intervene in crises and areas of instability, often well beyond Europe's shores. Consequently, Europe needs to become a more effective contributor to global security – both to safeguard its own interests and to promote its values. Such a vocation for ESDP, focused on crisis-management operations, sits comfortably alongside the role of NATO. Indeed, Europe ought to have a distinctive value-added to contribute, being able to deploy not only military means but also such civil resources as police and government experts – not to mention aid and trade. And finally, effective interventions and efficient use of resources require Europeans to co-operate more closely, pooling their efforts not just on multinational operations but also in industry and indeed the research laboratory.

Its hesitant application...

However, this new orthodoxy has scarcely taken hold when the difficulties of applying it have become apparent. Crisis-management operations call for very different military capabilities from those required to confront Soviet tank armies on the inner German border. The process of converting European militaries in line with this new vocation has been agonisingly slow. Time and again, the experience of real-life operations has demonstrated Europe's lack of such key "enablers" as military transport, whether big airlifters or helicopters, and communications systems. Yet an unholy alliance of innate conservatism and vested interest has acted as a powerful brake on the necessary re-direction of investment.

Perhaps for that reason, the operational impact of ESDP (22 operations to date, the bulk of them civilian) has been broad, but also shallow. To take just one example, the Europ ean response to the 2003 "rose revolution" in Georgia – the dispatch of 10 judges for one year – has been exposed by subsequent events as wholly inadequate. Similarly, it seems hard to believe that the 20-strong security sector reform mission to Guinea-Bissau is going to have much influence on that country's decline into a narcostate.

For here is a further practical problem in implementing the orthodoxy – the fact that the civilian capabilities which should be Europe's distinctive forte seem in even shorter supply than the military. The ill-starred police training mission in Afghanistan did not achieve its original target strength of 200 until early 2009, almost two years after it was launched and many months after European heads of state and government had undertaken to double it to 400.[2] The European Gendarmerie Force, established with fanfare in 2005, claims to be able to deploy 800 paramilitary police within 30 days – but despite President Obama's appeal at NATO's Strasbourg summit for more European help, the ensuing weeks saw no advance on France's isolated offer of 150 gendarmes. All of which rather gives the lie to Europe's claim to be able to approach areas of crisis and instability with a well-balanced and "comprehensive" approach.

Equally, six years after the first ESDP operations were undertaken, no sense of guiding strategy has yet become apparent. It was perhaps unsurprising that initially there should have been an element of first-come, first-served in European readiness to intervene – the aim of proving the system and gathering operational experience was a legitimate subsidiary purpose. But the continuing failure to define Europe's regional interests and priorities – the so-called review of implementation of the European Security Strategy at the end of 2008 was a sad missed opportunity in this regard – means that Europe's operations still have the air of a set of haphazard adventures. After five interventions of one kind or another in Congo since 2003, European governments evidently felt no difficulty or compunction in turning down the UN Secretary General when he asked for further help in eastern Congo in the autumn of 2008. With no policy towards Congo, this shameful failure to act could not be criticised as a violation of it.

Nor have the industrial and research policies fared much better. European defence ministers have recognised that, with their aggregate spending on research and technology a paltry one-sixth of US expenditure, they badly need to "spend more, spend better and spend more together" on defence research and technology[3]. To this end, they have agreed a target of 2% of overall defence spending. Yet in 2007 their aggregate level of R&T spend actually fell back, to just under 1.3%.

Similarly, after the major industrial defence consolidations of the 1990s, that process too seems to be stalled, or even going backwards; France and Germany are back in the business of promoting national champions while EADS, the flagship Franco/German/Spanish consortium for the new millennium, now frets that it looks too French in Germany and too German in France to win government favour and orders. The need to restructure the land and sea systems sectors is widely recognised; but governments prefer to wait and hope that, under the unsustainable burden of too much capacity and too few orders, the competition buckles first, leaving their national industry as "the last man standing".

...the traditionalist reaction and the gathering doubts

So, European governments have been slow to give substance to the new orthodoxy. And now the doctrine itself is showing signs of fraying at the edges. The evidence of their deeds demonstrates how many European governments, though theoretically subscribing to the European Security Strategy's aim of being "more active, more coherent and more capable", quietly prefer to sit on their hands. Austria, after acting as recruiting sergeant for the 2006 operation in Congo, initiated during the Austrian EU

Presidency, ended by contributing a total of four officers – all assigned to the Operational Headquarters in Potsdam. Europeans are maintaining on deployments an average of less than 5% of their total military manpower – whilst claiming to be stretched to the limit of their capacities. In recent years Bulgaria, Cyprus, Greece, Lithuania, Malta, Portugal and Spain have deployed less than 2%.[4]

The recent near-doubling in size of the European Union makes a consensus in favour of activism no easier to achieve. The new member states of eastern and central Europe have little history of global engagement, and often little appetite for overseas interventions. Rather, they will tend to look at a newly re-assertive Russia and wonder if it was right so readily to dismiss any prospect of direct military threat to the territory of Europe. The melting of the Arctic ice suggests a whole new domain for resource competition with Russia in the high north.

Meanwhile, the actual experience of expeditionary operations has given even the most enthusiastic pause for thought. After eight years in Afghanistan – the theatre where by far the greatest number of European forces are deployed, albeit under a NATO flag – it is increasingly hard to be sure what has been achieved beyond the de-stabilisation of neighbouring Pakistan. Nor is there any European consensus on the virtue of repeated interventions in Africa, which – in the absence of serious efforts to deal with the root causes of instability – can seem all too much like patching up the same drunk in the emergency room every Saturday night.

Even more worrying, the universal applicability and inevitable triumph of the principles of liberal democracy no longer look quite so certain as when President Bush promised to "extend the benefits of freedom across the globe" in his 2002 National Security Strategy. Even the appealing President Obama has acknowledged that "Jeffersonian democracy" may not be right for Afghanistan, at least for now. Of course, this is only realism; but too much realism can make Europeans feel uneasy, as when Secretary of State Clinton declined to tax her interlocutors on human rights on her first visit to China. With the new administration also ready to mend fences with Russia, the disturbing thought begins to take hold in Europe that President Obama, though smarter, nicer and politer than Mr Bush, may think and act like an American – and that Europeans had better come to terms with the thought that the United States is not a European power.

To add to the doubts about the unassailable rightness of liberal interventionism, Europeans are becoming increasingly aware of the limitations of the traditional division between on the one hand defence (the business primarily of the military, and played "away") and on the other of security (the business of police and intelligence services, and played at home). Governments are structured to embody this division, which is reflected in the way that Brussels works – not only in the restriction of ESDP to "crisis management" operations outside Europe, but also in the strict stipulation that the very substantial sums of EU money now available for the European Security Research Programme (ESRP) cannot be spent for military purposes.

But the reality is that defence and security are now increasingly bleeding into each other. What European armed forces do in Afghanistan or in Lebanon has a direct impact, for good or ill, on the safety of the streets of European capitals. Governments may maintain a clear distinction between the responsibilities of the Ministry of Defence and the Ministry of the Interior; but European publics will not indefinitely sanction defence expenditure unless they can see how it relates to threats they perceive as real. As George Robertson thundered in the aftermath of last winter's bank bail-outs: "I give this solemn warning to Europe's political leadership. If you do not use budgets on real defence needs, you will risk some of the anger that is focused on bankers. Spending scarce tax payers' money on heavy metal armies, undeployable troops or the wrong helicopters is a potentially blood-boiling scandal".[5]

The French 2008 Defence Review made a particular feature of ensuring that the military played a strong role – and that the public understood them to do so – in support of the civil power responsible for the security of the French homeland. Similarly – and irrespective of the theological distinctions made in Brussels – technology that will enable Slovenian infantry to talk to a Swedish fire support unit is basically the same as technology which will enable the different emergency services to communicate effectively in any capital of Europe. In other words, it is an artificiality to pretend that there is "security technology" which is distinct from defence technology – as is evidenced by the readiness of the big defence companies to bid for the contracts on offer under the ESRP.

Here, therefore, is a conjunction of uncertainties – about Europe's proper role in the world, how far it should be acting in concert with the US in support of "western values", whether it has the real will and means to be an effective contributor to global security, and how that relates to the security of populations at home – which, in the summer of 2009, gives rise to significant self-doubt. In the context of NATO, and more specifically that organisation's need to redefine its "strategic concept" over the next year, this has already been dubbed "a crisis of identity". But, in truth, the same hesitations are hobbling the development of Europe's security and defence policy as well.

The risk is that, particularly as governments come to survey the fiscal wreckage left in the wake of the global economic crisis, defence slides further down the list of public priorities in the European democracies. A good number of European member states would, privately, prefer the quiet life – to adopt the strategic posture of Switzerland. Such member states have no enthusiasm for being "busy" in the wider world and would, variously, be very content either to continue to shelter under American patronage and protection, or alternatively to establish a rather different relationship of dependence with the energy giant to the east.

The need for global engagement

But Britain or France will never allow such quietist visions to dominate the mainstream. As President Sarkozy dramatically framed it at the 2009 Munich Security Conference: "Do you want peace or do you want to be left in peace? It isn't the same policy, it isn't the same strategy, and the consequences aren't the same. If you want peace, you have to give yourselves the means to exist as an economic, financial, political and military power. You want to be left in peace? If so, you have to curl up very small, stay in your corner, cover your eyes, block your ears, and not talk too loudly, and for a time you will be left in peace. Until the moment when it's discovered that you haven't got the means to defend yourself. But at that point, it will be too late".[6]

Moreover, whilst the Americans in the early years of the ESDP would have been very ready for the Europeans to give up their pretensions and revert to sheltering under Uncle Sam's leadership, that time has now passed. Washington has come round to support the idea of a more active European contribution to global security – if only those Europeans would back up their words with action! As President Obama succinctly put it in the margins of the NATO summit, "We want strong allies. We are not looking to be patrons of Europe. We are looking to be partners of Europe".[7] Atlanticists as much as Europeanists need to take heed of this message: the hallmark of the Obama administration is pragmatism, and it will not waste its time with those who cannot deliver. The importance of the transatlantic relationship will be measured in Washington by the yard-stick of utility, not sentiment.

Ironically, European publics seem more naturally sympathetic to the idea of Europe as an active contributor to global security than are their leaders. Polls consistently show majority support for European involvement in peace-keeping – even if that support tends to evaporate when actual combat operations are involved, as in Afghanistan. Europeans are pleased that their navies are successfully deployed in Somali waters, protecting both their own shipping and the UN food ships which relieve the suffering of Somali refugees. They are frustrated that more cannot be done in Zimbabwe or Darfur – and recognise the value of a deployment such as the recent operation to protect Darfuri refugees in Chad as something less than ideal, but better than standing idly by.

There are broader arguments, too, for Europeans to continue to invest in their defence and security capabilities at a time when global power is being re-distributed more rapidly than ever before. The big winner from the recent economic crisis has clearly been China – an "emerging power" which has now unambiguously emerged. China evinces no inclination to throw its growing military weight around in the international arena. But its prodigious appetite for minerals and energy resources, and lack of scruple about who supplies its needs, have not only challenged Europeans' economic interests and development efforts in Africa, but have also, from Sudan to Zimbabwe, emboldened unattractive regimes which Europe has been trying to manoeuvre into behaving better. Thus both interests and values argue for Europe to continue to remain prominently engaged in Africa, with cooperation with the UN and the African Union on conflict- and crisis-management an important part of that engagement.

Examples could be multiplied. The two-state solution to the Palestinian issue, which Europe has so long advocated and which again represents an alignment of European self-interest with what is objectively right, is unlikely to be implementable without substantial European peace-keeping forces on the ground.[8] The common thread is the need for Europeans to act, and to act together. As Javier Solana expresses it, "It really is that simple: either Europe works together or we become strategically irrelevant".[9]

Making it happen

In sum, the "new orthodoxy" on European defence described above remains fundamentally valid. Doubts and hesitations which have begun to attach to it are cause not to abandon it, but rather to renew efforts to make it happen.

There is no particular mystery about what needs to be done.[10] Member states will remain hesitant about contributing to operations as long as there is no shared understanding of the priorities for European intervention. Proper regional strategies are needed. Common funding must be expanded, so that those who run the risks of contributing do not also get saddled with the lion's share of the costs. And amateur improvisation in the running of European operations must finally give way to real professionalism, by the creation of a combined, civil-military Operational Headquarters in Brussels, and the institution of a de-politicised operational audit ("lessons learned") system.

On capabilities, remorseless political pressure must be applied to militaries across Europe to accelerate overdue modernisation, shedding surplus manpower and investing not in the big "platforms" (from bombers to aircraft carriers) that industry would like to build for them but in less glamorous equipments such as decent communications which modern operations actually need. Most member states are overdue for a fundamental defence review, which asks where the defence budget is actually going and what benefit comes out of it. And the efforts to pool and share resources which the French pushed forward in their recent EU Presidency should be pursued by a strengthened European Defence Agency.

Complementary civilian capabilities, on which the EU has prided itself, but which turn out in practice to be largely an illusion, must be brought into being; the role of member states as "gang-masters" should be complemented by creation of a civilian reserve corps of qualified individuals under contract with either the European Commission or the EU Council Secretariat.

The principle of pooling efforts and resources must apply equally to the defence industrial base. Member states must honour their commitment to invest much more in research – and to do it collaboratively. And the consolidation of the European defence industry needs a new impulse – something which in practice depends on joint action by the German chancellor and French president.

In addition, the internal and external aspects of security must be more tightly integrated (involving closer co-ordination of how "military" and "security" budgets are spent, and the bringing together of the relevant staffs in Brussels to learn of each other's preoccupations, even existence). As the European Security Strategy notes, "The post cold war world is one of increasingly open borders in which the internal and external aspects of security are indissolubly linked". All those involved have spent the years since this truth was promulgated trying to ignore it. But within, say, the next 20 years, we can expect to see the first national "Ministry of Security" created in the EU bringing together internal and external security functions. Until that happens, Brussels may have to play a particular role in ensuring this form of vital co-ordination – and should be particularly well placed to do it if and when the Lisbon Treaty comes into force, and with it a new European foreign policy chief with one foot in the college of Commissioners.

The new Lisbon Treaty arrangements are vital. Defence and security are the two subjects where Europeans' concerns about national sovereignty run deepest, where there is least readiness to cede power to Brussels institutions, and where therefore the strongest efforts at leadership are required from the centre to overcome the centrifugal instincts of individual member states. Lisbon will allow such leadership to be exercised, assuming that the right personalities are appointed to the relevant key posts of President of the European Council, and new foreign policy chief. They will be supported by a new European External Action Service (EAS). This will provide the opportunity not only to make coherent use of all the instruments of foreign policy – it is vital that development aid is brought fully within the ambit of the EAS – but also to bring proper management and organisation to the planning and execution of common external policies.

The treaty has the further virtue of providing a basis for what it calls "permanent structured co-operation" in defence. This will allow the formation of a pioneer group – or, better still, a number of overlapping pioneer groups enabling the more enthusiastic or committed to deepen their co-operation in the various different aspects of defence, rather than advancing at the pace of the slowest ship in the convoy of 27. Properly designed, this system will employ that age-old Brussels motivator, the fear of exclusion, to encourage member states to try harder at defence and to commit to closer co-operation. It will also force the member states to quantify how they use their defence resources and what they get out of them – a necessary but currently neglected precondition for using them to best effect.

The global age is upon us even faster than futurologists had foreseen. Global developments underline the urgency of EU member states living up to their commitments to come together as a more active, more coherent and more capable contributor to global security. Leadership is the key, and the Lisbon Treaty contains the minimum institutional arrangements to allow this to be created and exercised.

Chapter 4

Options in dealing with potential members and other neighbours

Paweł Świeboda

The question of borders has haunted the European Union since the end of the cold war. The world before had been much simpler. Belonging to the western camp and projecting decent democratic credentials meant one sooner or later would be welcomed into the fold of European and Euro-Atlantic organisations. After 1989, the lines became blurred. The "big bang" accession of 12 new member states in the years 2004-2007 was about a reunification of the continent but it inevitably produced symptoms of complete exhaustion and indigestion in some corners of the European Union. If enlargement is to continue, it will have to take recourse to a different paradigm, that of a global Europe. The possibility of extending the European Union's membership further will only be contemplated if the EU itself decides to be an open and confident actor in international relations.

The continued appeal of enlargement

Enlargement continues to have significant transformative power in the candidate and potential candidate countries although not everywhere does its appeal remains irresistible. Turkey has achieved remarkable progress undergoing the second great modernisation effort after Atatürk. EU membership has been instrumental in this process even though European pressure has very often been openly challenged as counterproductive. The calls on Turkey to amend article 301 of its constitution "has made matters worse", as the foreign minister, Ali Babacan once put it.[1]

The EU does not have the same power of attraction in the western Balkans as it did for the central and southern European new members. Apart from the complexity of the post-civil war situation, it is due to lost historical momentum. The myth of the big bang enlargement was about overcoming historical divisions of the continent. That myth is no longer there. Regional trade and investments in the Balkans are low. Croatia is the only Balkan country with a strong prospect of accession in the near future. Nevertheless, the perspective of EU accession has been key for improving relations with Serbia and with Croatia's own minorities. Reform of the judiciary, return of Serb refugees and improved relations with the neighbours are all the result of the looming EU process but future progress will be protracted and will demand constant effort.

Apart from the Balkans, there are a group of candidates for membership in eastern Europe with Ukraine, Moldova, Georgia, Armenia, Azerbaijan and possibly Belarus. They are a diverse group of countries, with different paths of political and economic evolution and different prospects. The European choice of Ukraine and Georgia can generally be taken for granted, most likely encouraging the other countries to follow suit. They will gravitate towards the European Union although the process can be expected to be a long and turbulent one. This largely depends on the success of implementing the EU's latest offer within the eastern Partnership as well as the track record of enhanced partnership agreements which are being negotiated with some countries of the region. It is likely that Ukraine will be the first of the eastern European neighbouring countries that will file a membership application. The timing is likely to be after the new enhanced agreement remains in place for some time and exerts tangible impact. This means 2011 at the earliest.

Preconditions for further enlargement

Viewed as a political project, further enlargement to include western Balkan countries may be at least remotely appealing inside the EU as a means to exert a stabilising effect across the area. In addition, it could help to remove the remorse Europe feels over not being able to prevent conflicts in the region in the 1990s. Turkey is a more difficult case in the cultural but also political and economic sense. The one single argument which resonates strongly with most supporters of Turkey's EU entry is the power of example it would generate in the Muslim world, the relations with which will be one of the defining challenges of the coming decades. In spite of its uneven record, Turkey's example of modernisation has been observed closely across the Muslim world and serves today as one of the most convincing arguments for intercultural dialogue. Having Turkey among its members, the EU would be in the position to talk to Muslim countries from a position of confidence and credibility.

David Milliband described enlargement in a 23 June speech in Warsaw as being about the deepening of liberal democracy. This way of approaching enlargement, aimed at moving beyond the usual European dichotomy of enlargement versus deepening, holds true for Turkey as much as it does for Ukraine and other potential eastern European candidates. It is especially true given that the political case for the accession of Ukraine and other eastern European states is more difficult to make in the context of their patchy progress in the transformation process. The EU is unlikely to admit to the existence of a strategic dimension of its policy towards the eastern neighbours in the face of a resurgent Russia and therefore the set of arguments which relate to the basic values on which the EU is based serves as a more appropriate framework for examining the future of enlargement.

The other side of the coin is the future developments inside the European Union, its changing nature and the role it wants to play in the world. If the EU is to realise its future as a regulatory power, the more weight it carries, the better; and it is going to carry more weight with a larger size. The internal logic of the EU should also make it easier to conceptualise a larger size with less attention focused on advancing the integration process and more emphasis on a pragmatic problem-solving approach.

As for the economic rationale, one could argue that the key EU policies are easily expandable, including the internal market, while the extension of others is in line with the broader European objectives, especially when it comes to the energy and climate change policy. Potential candidates for accession are not always countries rich in natural resources, although Ukraine has abundant mineral resources. They tend to be crucial transit countries, neighbouring on oil and gas powerhouses. As was the case on previous occasions, issues with financial implications such as agricultural policy and regional policy will prove to be the most difficult chapters in negotiations with future candidates. However, the exact format of these policies in the context of the next 10-15 years is difficult to anticipate.

When it comes to public attitudes, it is clear that the European Union is still gripped by an enlargement fatigue although the picture is not as bleak as often assumed. The *Bertelsmann Stiftung* commissioned a study of public opinion on enlargement in 2006 which demonstrated that the Europeans tended to believe that the European Union would continue to enlarge. As many as 72% of the Dutch, 70% of the French and 68% of the British said that in their opinion the EU would enlarge beyond the 27 members.[2] When asked about Turkey's prospects, 58 % of the British people said that Turkey would be in the EU by 2020 and 53% of the Dutch said the same. The figures were much lower in the new member states with only 13% of Slovaks and 17% of Poles believing that Turkey will be an EU member in 2020.

Enlargement is clearly a communication challenge. The European Commission regularly puts emphasis on this issue in its enlargement strategy papers. One way of reassuring the public has to do with extending provisions on enlargement in the Treaty of Lisbon by means of a requirement to notify the European Parliament and national parliaments of each application to join. There is also new language stating that "conditions of eligibility agreed by the European Council shall be taken into account" in the process. Another way of persuading citizens of the merits of a future enlargement should have to do with publicising the effects of the latest enlargement and showing that all those who created nightmare stories have been proved wrong. The one caveat remains that the integration of Bulgaria and Romania has been widely seen as premature and has a negative impact on the perception of the entire project.

What the big bang enlargement has demonstrated

The big bang enlargement of 2004 and 2007 proceeded surprisingly smoothly as far as the mechanisms and institutions are concerned. When it comes to the economic dimension, migrant workers from the new member states filled in jobs at the lower end of the hierarchy. This was mostly a success story although some problems emerged as a result. There was a symmetrical equivalent to the Polish plumber phenomenon in western Europe which was symbolised by the evacuated patients of central European hospitals which had to close down due to the heavy burden of migration. The lesson there is not to withhold free movement of people but to prepare for it by anticipating demand patterns and better assessing the readiness of economies to cope.

In terms of institutional functioning in the Union, enlargement has not been a major revolution. There are more people in the room and the quality of discussion has suffered. It is now rare for ministers to have genuine exchanges in council sessions. This is mostly because it is objectively difficult but also because people rarely attempt to have a proper discussion. The general assumption is that at twenty seven, this is impossible. When it comes to the efficiency of decision-making, the experience has been remarkably positive. The CEPS study "Old Rules, New Game: Decision-making in the Council of Ministers After the 2004 Enlargement" indicated that the Council's ability to adopt legislation has not been effected. Although there was a drop in the amount of legislation passed immediately after enlargement, the total number in 2006 increased to "almost the same level as prior to enlargement". Among the many qualitative changes noted, the study showed that the number of pieces of legislation adopted at the 1st reading was gradually increasing. It is worth remembering that enlargement coincided with the climax of the Commission's better regulation initiative which aimed at reducing the number of legislative proposals which are not absolutely vital. Similar conclusions have been reached by Professor Helen Wallace in her study on the effects of enlargement.[3]

The enlarged European Union has remained faithful to the community method although the inclination to solve problems by intergovernmental deals has increased. Large member states have been crucial to reaching consensus on the most difficult dossiers such as the financial perspective and the new Treaty. The Commission has provided inspiration but its ability to exercise influence politically has diminished. That trend, however, precedes the big bang enlargement.

Improving the methodology of enlargement

The EU has perfected the methodology of enlargement over the years to the degree that there is little room for further improvement. There are now benchmarks to reach before the process of negotiating chapters is opened which is a new device compared to the big bang enlargement of 2004 when only benchmarks for closing chapters were in use. The change is useful because candidate countries can prepare much better for what they can expect and what will be demanded of them in the course of negotiations. The methodology has evolved to such an extent that the Negotiating Framework for Turkey has some questionable provisions from the point of view of their conformity with the treaties. Article 49 of the Treaty cannot lead to an agreement which does not have the effect of bringing a country into the European Union. And yet the Negotiating Framework for Turkey states that the negotiations are an open process, the outcome of which cannot be guaranteed. Should accession not take place, Turkey is to be anchored in European structures "through strongest possible bond". Permanent safeguard clauses are envisaged in the

Negotiating Framework with respect to the freedom of movement of persons, structural policy and agriculture. This is also dubious because the EU is tasked in the treaty (article 2, TEU) to maintain in full the *acquis*. Permanent safeguards would be an erosion of the *acquis,* not a protection of it.[4]

On the spur of the big bang enlargement in 2004, the European Union designed a policy which aimed to avoid new dividing lines between members of the club and the less distant outsiders as well as to create a zone of stability in the immediate proximity. The European Neighbourhood Policy became one of the EU's most established flagship projects, a trademark for its engagement with the eastern and southern neighbours. However, it was from the beginning a function of the EU's internal evolution and had the objective of cushioning the Union against any unwanted turbulence beyond its borders. The intention was more to protect the EU and its achievements than to expand its ability to project influence into new geographical zones.

At least three major changes have occurred since the launching of the ENP and influenced the context for the EU's relations with its neighbours. Firstly, the commonality of interest between the neighbours and the EU has grown. Secondly, the process of globalisation has meant that the neighbours themselves have faced greater competition which they have not always been able to address adequately. Thirdly, the emerging powers have arrived on the EU's doorstep.

Economically, and increasingly politically, there is more than one centre of gravity for entire groups of countries which have previously not faced such stark choices. Investment flows into the non-EU Mediterranean states are no longer dominated by European capital. The most important players are the Arab Gulf states, investing strongly in telecommunications, and to a lesser extent, the east Asian countries, especially China.

Natural differentiation among the neighbours

Looking across the EU's proximity, the political, cultural and economic character of the EU's neighbouring countries could hardly be more diverse. Differences range from economic governance to respecting the rule of law and democratic standards. Unlike eastern Europe, which managed to build trade links during communism, the Mediterranean countries barely carry out any significant exchanges between themselves, clearly losing the benefits of economies of scale. On top of that, there is the difference in political systems.

Over the years, two groups of countries – eastern and southern – emerged in an almost natural fashion. The first consisted of the EU's direct neighbours, the second included not only the EU's but also Europe's neighbours situated on a different continent. Aimed at bringing together the east and the south under one umbrella, the European Neighbourhood Policy (ENP) attempted to create a holistic approach of integrated neighbourhood policy with tailor-made strategies, embracing the needs and requirements of each country concerned. Initially, the cooperation within each dimension was different in nature and the EU found itself balancing the bilateral, multilateral and regional relations hitherto developed. Initially, relations in the south elaborated within the Barcelona Process were essentially multilateral and regional while the links with the east were entirely based on a bilateral framework of cooperation. Eventually a common strategy has emerged, providing the south with a bilateral dimension through the Action Plans and boosting multilateral and regional activities such as Black Sea Synergy or energy and transport networks in the east.

Eastern Partnership and the Union for the Mediterranean

After five years of implementing the ENP, it is clear that a more coherent platform is now needed to ensure that the eastern and southern neighbourhood gains a strategic orientation. Two organising umbrellas have been proposed recently in the form of the Union for the Mediterranean and the Eastern Partnership. They arrive as new devices in the succession of initiatives that recently featured the "ENP Plus" concept elaborated in Berlin. It is all the more important for them to gain real substance and to attract genuine commitment on the part of the member states. In that sense, they are still to be tested in practice.

From the point of view of the objective they intend to meet, the Union for the Mediterranean and the Eastern Partnership are two sides of the same coin. They are about ensuring that the eastern and southern neighbours find themselves firmly in the European orbit. The spectrum to be filled is that between the current status and that of a candidate country – one which can be called "enhanced association" or "association plus". The relationship should be more institutionalised and more project-based at the same time. A platform is particularly needed for the EU to conduct political dialogue with its eastern neighbours and discuss prospects of the region, e.g. in the form of the Eastern Partnership Council at the ministerial level. A high level figure, ideally a Member of the European Commission should be charged with coordinating work on the Eastern Partnership.

Separate coordinators might be appointed to oversee the implementation of the most important projects. An Institute for Eastern Neighborhood Studies (IENS) could also be created with independent analysis and recommendations.

The higher level of political interaction must be accompanied by tangible progress in mutual relations in key areas. The most important project in that category is the new generation agreement with Ukraine on which negotiations are ongoing. It will have the format of a deep free trade agreement and as such it will constitute the most advanced form of relationship between the European Union and a non-member country, apart from the European Economic Area, the Schengen association with Norway and association with Turkey which includes a customs union and far reaching provisions on the movement of workers. It will have all the characteristics of an association agreement. Strong institutions need to be created within that framework, including an Association Council with the competencies to allow for binding commitments on behalf of both partners. The European Union should live up to the promise it made at the outset of the negotiations when it suggested an extensive legal harmonisation to take place in Ukraine with the EU's assistance. There should be no backtracking on that offer. The EU should not yield to the temptation of watering down the Association Agreement, so as to make the framework more easily transposable in other neighbouring countries. It is in the European Union's interest to achieve the most far-reaching convergence of legislation with the Eastern Partnership countries.

The Eastern Partnership should look ahead to the implementation of the Association Agreement with Ukraine and subsequently with other eastern neighbours. It ought to launch a process by means of which the progress of the relationship will be consistently reviewed and appropriate decisions taken in due course. In 2011, a review should be conducted of the Association Agreement on the basis of an assessment prepared by the European Commission. All options should be open to Ukraine and the Eastern ENP countries on the basis of that review. Should Ukraine or other neighbours decide that they have reached the level of preparedness and political readiness to envisage applying for membership in the European Union, they should not be discouraged from doing so. Clearly, this decision should be based on tangible evidence and positive track record in implementation of the new generation agreement with the European Union.

An adaptation of the neighbours' regulatory regime to that of the European Union remains the most important part of the association agreements being negotiated. A cost-benefit analysis will indicate the value-added of that "deep" aspect of free trade both with the EU and other countries in the region. Limiting barriers to trade and achieving higher regulatory convergence would result in boosting growth and investment and contribute to enhancing the overall business environment. However, policy adjustments will not be easy to undertake and therefore the neighbours should receive as much assistance as possible. If Ukraine and others are expected to adopt the EU's environmental legislation, including such costly frameworks like the urban waste water directive, they have to be offered tangible financial assistance. The process has to rely to a large extent on external anchors.

A number of sector-specific issues should be identified as strategic, aimed at securing more far-reaching commitments on both sides. Energy and climate change belong to this category, with the Eastern Partnership (EP) countries being an important hub for the transit of energy as well as an area where enormous progress is needed from the point of view of energy efficiency. The Eastern Partnership process should cater for that purpose. Specifically, the scope of the Energy Community Treaty should be extended to all the countries in the Eastern Partnership. Particular attention should be devoted to the modernisation of the EP countries' energy infrastructure which should receive priority under the new Neighbourhood and Partnership Instrument. EP countries should also be progressively integrated into the European distribution networks of gas and electricity. Cooperation in the area of security and defence should be enhanced, especially in the area of crisis management and non-proliferation. The European Defence Agency should gradually engage EP countries in close institutional dialogue. The contribution of EP countries to EU missions abroad should be duly recognised. A crisis management watchdog comprising experts in the field would help to streamline the process of resolving problems and mitigating risks of conflict spreading within an entire region.

Direct experience and people-to-people contacts are always important in times of transformation and change. They are made easier by conducive travel regimes. Some countries in the eastern neighbourhood have already benefited from the unprecedented willingness of the EU to offer flexible conditions of entry and visa liberalisation. Ukraine and Moldova have signed visa facilitation agreements. Two problems remain, however, even among those neighbourhood countries with relatively easy access to the European Union. They have to do with the cost of the Schengen visa which remains high for many people in eastern Europe as well as with the processing of visa applications. The answer to the first concern should lie in the gradual elimination of the visa fee for citizens of countries participating in the Eastern Partnership. This should also be applied to the citizens of Belarus. In addition, the Chisinau practice of a joint collection centre for visa applications should be used elsewhere in the region. Genuine progress in the handling and processing of visa applications would be very important from the point of view of promoting the EU among citizens of neighbouring countries.

Just as the Eastern Partnership is the new umbrella concept for more strategic relations with eastern neighbours, the Union for the Mediterranean (UfM) is meant to achieve the same objective with respect to southern neighbours. As pledged by the 43 partnership nations in a Joint Declaration of the July 2008 Summit for the Mediterranean, it aims to "transform the Mediterranean into an area of peace, democracy, cooperation and prosperity". This is an ambitious task given that the south Mediterranean, although not a region of failed states, has been one of smart authoritarianism, where a degree of political pluralism is allowed but serious opposition movements are ruled out from the outset.

In order to make UfM a collective forum and to "improve the balance and the joint ownership", the heads of state and government established co-presidency, which will consist of one co-president from the EU and one from the Mediterranean partner countries. Although the concept aims to enhance the political dimension of the project, it will have to be tested against the range of political animosities and underlying tensions abundant in the region. Generally, overcoming the enormous cultural and economic diversity of the Mediterranean area will be a key challenge for the UfM. Clearly, a lot of political will needs to be generated for the co-presidency concept to operate effectively.

If the UfM is to gain genuine momentum, it needs to address the deficiencies of the Barcelona Process in terms of insufficient means, lack of structures, weak governance and shortcomings in trans-Mediterranean market integration. It must also tackle the political question of addressing the tensions between southern partners which keep the political establishments preoccupied and less able to embark on the process of integration necessary for economic reform. In addition, the project-based method cannot be an end in itself but rather a starting point to a closer economic partnership, embracing the fundamental tenets of macro- and microeconomic policy.

Based on, the way it has been planned so far, the Union for the Mediterranean will cover six major fields: environment and sustainable development; transport (notably the maritime highways development plan); a Mediterranean civil protection network; alternative (particularly solar) energy sources; higher education and research; an initiative to encourage the development of micro, small and medium sized enterprises, and a few sector-oriented projects: water access and management, professional training, youth exchanges, modernisation of public health services, agriculture, urban development and regional planning.

The key areas of the UfM have to do with tangibles such as protecting biodiversity, managing the growth in the Mediterranean traffic with the impact of congestion, greenhouse gas emissions and pollution, security, civil protection and the solar energy plan. Hence, the specific projects include modernising the “trans-Maghreb” railway and creating the western Mediterranean motorway of the sea. The Solar Energy Plan could well become a flagship project of the UfM given the current 4% share of renewables in the energy mix of the Mediterranean countries and the extremely favourable sunshine conditions in the area. The Solar Energy Plan would provide for the construction of solar energy generation capacity, involving private investors and launching exports of renewable energy to Europe. Although concentrated solar power is not technologically advanced to the point of being applied across the board, a number of power stations are currently at the planning stage. The costs of producing energy from solar concentration are decreasing sharply which should be an impulse for investors to become interested in enlarging commercial solar energy production. Solar energy should become competitive by 2020.

Ensuring an appropriate level of funding for the UfM will be a challenge but a range of existing financial mechanisms such as the one used within the scope of the Northern Dimension could be a useful source of inspiration. It is clear that the funding will not come from a single source but it will have to be provided by innovative financial engineering combining private sector participation, bilateral contributions from EU member states, contributions from Mediterranean partners, engagement of the international financial institutions, regional banks and other bilateral funds, the Facility for Euro-Mediterranean Investment and Partnership (FEMIP) and the European Neighbourhood and Partnership Instrument (ENPI).

Options for continuing the process of enlargement

Enlargement remains the best answer to the twin challenge of consolidating Europe’s global position and stabilising its neighbourhood. Given the different context both within the European Union and among the potential candidates, who are far less ready to join than the previous entrants, new ideas need to be elaborated on, ensuring that the benefits of the European vocation are realised. There are at least three possible scenarios of how enlargement could be continued.

One way is to carry on in the traditional fashion adjusting the pace of enlargement to the political expediency of the moment. In order to allay public fears, an Enlargement Adjustment Fund could be created on the lines of the Globalisation Adjustment Fund to address the key challenges resulting from the process of enlargement. The fund should be available to enterprises and localities which can demonstrate that they find themselves under strong competitive pressure from operators based in the new member states and have encountered job losses and factory closures as a result. This scenario presumes that the candidates for accession are increasingly determined to pursue membership and make steady progress in achieving political and economic readiness. The main difficulty would then come from the readiness and willingness of the current member states to admit new entrants.

The second way would be to envisage an “enlargement minus” model in which parts of the acquis would be taken out of the scope of the membership package. In a way the Union has embarked on this approach ever since it agreed the Negotiating Framework for Turkey which envisages the possibility of permanent derogations. One can also approach the “membership minus” model through the prism of the way the EU already functions, with its different modes of belonging – the euro, Schengen, parts of ESDP, Charter, etc. Thus, the new members would be joining old members who have decided not to take part in all policy areas. The forms of “membership minus” might even increase if the instrument of enhanced cooperation is used in the future.[5]

The third model is to design differently the accession process by means of creating a number of new intermediate stages. Countries could be granted “observer status” enabling them to take part in EU deliberations although not in the decision-making process. Full integration would then be a function of progress in key areas of community acquis. The value-added of this approach – which by definition cannot be an extensive one – would be to make sure both sides get accustomed to each other and better realise the commonality of their strategic interests.

It is clear that the first model, that of linear continuation of enlargement, is strongly challenged in the current debate while the latter two have not been elaborated and may require treaty change. Nevertheless, the European Union will clearly need to move beyond the existing range of options which envision fully-fledged membership or a relatively loose way of belonging by means of a neighbourhood status. It is very likely that the EU's proximity will define its strategic options in the coming years. The only way for the EU to respond is to create stronger bonds outside but increasingly also within the paradigm of enlargement.

Chapter 5

Neighbourhood policy: between grand rhetoric and modest tools

Helen Wallace[1]

On 7 May 2009 leading policymakers from the European Union convened the Prague Summit with political leaders from Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine in order to launch a new Eastern Partnership (EaP). It was high time for EU policymakers to review its relationships with these east European neighbours, as indeed with the southern neighbours (covered by the parallel initiative to develop the Union for the Mediterranean). The European Neighbourhood Policy (ENP) had run its course. However, while the precise content of the EaP remains sketchy, the evidence so far suggests that the EU has failed to learn the lessons of its previous policies towards this region. Home to some of Europe's most politically fragile and economically depressed territories, if the six target countries of the EaP are to emerge as stable partners the EU will need to dedicate much more serious attention to their needs and circumstances, and to the type of tools needed for the job.

By way of background

Almost twenty years on from the fall of the Berlin wall, there is a good deal of unfinished business. The new Russia has still to find its place in the post-cold-war system and other Europeans have yet to figure out what kind of relationships to develop with the Kremlin. Transformation processes leading towards functioning market economies and towards sustainable democracies are uneven across the post-socialist region. The global financial crisis has exposed disturbing vulnerabilities, including in some countries that are now EU member states. In both the western Balkans and the prospective EaP countries the economic outlooks are deeply worrying.[2] Anchoring democracy turns out to be a bigger challenge than the optimists had hoped in the post-1989 euphoria – and there is an intersection between political (in)stability and economic (in)stability, in particular for countries still in the process of establishing viable states and national identities.

On the positive side of the balance sheet the EU enlargement policy has been by-and-large a success – or at least so far. The 1995 enlargement brought into the EU Austria, Finland and Sweden, countries that have played pivotal roles in developing relationships with the wider Europe. Ten countries from the former Soviet imperium (along with Cyprus and Malta) joined the EU in 2004 and 2007, signalling the value of the magnet of EU membership in underpinning economic and political transformation processes. Moreover, it turns out that the EU itself has adapted better than many had feared to the day-to-day tasks of managing the EU27 – despite the failures (so far) to ratify either the Constitutional Treaty or the Treaty of Lisbon. Business in Brussels goes on pretty much as usual and without gridlock.

Nonetheless enlargement is not a universally popular policy within the EU either with policymakers or with public opinion. There remain worries about the EU being over-stretched. Some argued that Bulgaria and Romania had been accepted prematurely. During the referenda campaigns in France and The Netherlands in 2005 and in Ireland in 2008 concerns emerged about, in particular, the labour migration consequences of enlargement, increasingly cogent in a period of rising unemployment within the EU. The signs of enlargement fatigue have set in and even member governments that previously supported it have become much more muted on the subject.[3]

In principle the EU remains nonetheless broadly committed to a membership perspective for the countries of the western Balkans as well as for Turkey. Since July 2009 Iceland has also been added as a candidate. Pre-accession negotiations are under way for Croatia and Turkey, and could open with the former Yugoslav Republic of Macedonia (FYROM), if Greece and FYROM could reach an accommodation on their bilateral dispute. Yet making a reality of this commitment to further enlargement is also a persistent challenge. The negotiations with Croatia have been disturbed by a dispute with Slovenia. The negotiations with Turkey are proceeding only very slowly, partly because of the loss of momentum on the Turkish side, and partly with the reluctance expressed by in particular President Sarkozy and Chancellor Angela Merkel. The other countries of the group are some way off being engaged in a pre-accession process for reasons related to their individual circumstances. With the probable exceptions of Croatia and Iceland the time line for accession for any of these countries looks rather long. Thus the interim arrangements for linking these countries to the EU will need to be thought about as durable for the medium-term. This raises questions about the roles and capacities of the Regional Cooperation Council (RCC) (the successor to the Stability Pact for South Eastern Europe) and the Central European Free Trade Area (CEFTA) (remodelled as a trade forum for the western Balkans after its original members joined the EU).

From 2003 the EU set in place the ENP as an umbrella under which the EU would develop essentially bilateral action plans to thicken relationships with other neighbours both to the east and to the south, although excluding, in particular, Russia. The ENP emerged as a catch-all approach instead of the more targeted strategy (notably *vis-à-vis* Ukraine) which some EU foreign policy officials had advocated. On the one hand, it was intended that the ENP would produce a more coherent approach to the "neighbourhood" as a whole. On the other hand, the ENP was also devised as an "anything but membership" policy. Hence it was convenient to bracket eastern and southern neighbours together – and hence within the bureaucratic politics of the EU, and especially the Commission, responsibilities for ENP were firmly segregated from those for enlargement. As things have turned out it has borne disappointingly few fruit – and it has certainly not diminished the desire of some European ENP countries to set their sights on EU membership.

During the 1990s the discussions of EU enlargement and Nato enlargement went hand in hand. The 10 central and east European countries that joined the EU had all previously been accepted as Nato members, although especially in the case of the three Baltic countries this had been judged provocative by the Russians. Latterly it has become clear that the idea of Nato membership sooner rather than later, but EU membership later rather than sooner is not an easy option for the other neighbours either in the western Balkans or further east. In the case of the proposed EaP countries, Nato took a decision in Bucharest in 2008 to welcome the potential accession of Georgia and Ukraine, but this has not been activated yet, since this would be an intolerable provocation for the Russians. More nuanced reflection is needed on the interconnections between Nato and EU enlargement policies, as well as on the testing issue of how to manage the relationship with Russia.

The proposed Eastern Partnership

Explicit calls for a rethinking of the ENP mounted during 2008, with the call from President Sarkozy for a reinvigorated Union of the Mediterranean. This provided a catalyst for voices calling for a rethink of the relationships with the eastern neighbours, notably from the Czechs (who tabled the first "non-paper" in April 2008), the Poles and the Swedes.[4] A joint Polish-Swedish paper followed in preparation for the June 2008 European Council, which mandated the Commission to develop proposals.[5] This was given added urgency by the Georgian-Russian conflict in August 2008. The Commission paper of 3 December 2008[6] was endorsed in principle by the European Council of December 2008 and again substantively by the European Council in March 2009.[7] The Prague Summit of May 2009 brought together EU and target countries to affirm the commitment to take the EaP forward.[8]

The content proposed so far for the EaP remains only an outline, with much to follow by way of substance and method.[9] The Commission proposals are written in more ambitious terms than those of the ENP and emphasise the need for both bilateral and multilateral elements. Deeper bilateral engagement would include: association agreements (with the appropriate bilateral institutions); economic integration by means of "deep free trade areas" with each country, with sectoral elements that might include agriculture; "mobility and security pacts" to open up scope for free movement of individuals; and measures to promote energy security. The multilateral framework would have an "operational structure" including: biannual meetings of heads of government; annual meetings of foreign ministers (back-to-back with an EU Council session (foreign ministers)); and four "thematic platforms" with defined programmes of work and panels of experts. These thematic platforms would be: (a) democracy, good governance and stability; (b) economic integration within a Neighbourhood Economic Community and convergence with EU policies (including environment and climate change); (c) energy security; and (d) soft measures to promote contacts between people (cultural cooperation, education etc). Third countries (Turkey?) could be involved in the thematic platforms. It is envisaged that EU funding towards the area would rise from €450 million in 2008 to €785 million in 2013, with additional resources also for "regional" initiatives and loans from the

European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD).

Reactions to the proposals

The member states of the EU gave a green light for the development of the EaP at the European Council sessions of December 2008 and March 2009, but without an extended discussion by EU political leaders, hardly surprising given the burden of the global financial crisis. The main inputs so far have come either from the Commission or from those few EU member states with a clear interest and declared ambitions in relation to the EaP or to individual target countries. Predictably, the Polish Government has been particularly proactive, understandably given its long-term concern for upgrading the EU-Ukraine relationship and for keeping open the possibility of a membership perspective. The Swedish and Czech Governments, each in the Council presidency in 2009, have been supporters of the EaP. The Prague Summit of May 2008 in essence confirmed but did not refine the proposals.

Beyond this small group of member states the extent of engagement is much less clear. The Lithuanian Government has welcomed the initiative. Both French and Italian ministers have signalled the need to find ways of associating Russia and Turkey with the development of the EaP. This point was stressed in an "advisory letter" to the Dutch Government by the Advisory Council on International Affairs,[10] which emphasised: a) the need not to neglect Russia and Turkey in developing the initiative; b) the importance of making the EaP multilateral; c) the case for keeping open the prospect of EU membership as a longer term goal; and d) the link to Nato policy. Germany and the UK have indicated only general support for the EaP. There is continuing discussion about the allocation and availability of funding under the existing ENP financial arrangements and about the division of resources between southern neighbours in the Union for the Mediterranean and the eastern neighbours of the proposed EaP.

Some dogs have not barked in the discussion so far, or at least not yet very loudly. Significantly some EU countries close to the EaP neighbours have been reticent in the public debate, most notably Greece, and perhaps more understandably Bulgaria and Romania (the Romanians have made proposals for a "Black Sea cooperation platform" on migration linked to the problems in Moldova). These three are all "Black Sea" countries and members of the Black Sea Economic Cooperation (BSEC) process, agreed in 1992, established in 1994 (with a secretariat in Istanbul) and turned into an "organisation for regional cooperation" in 1999. BSEC includes as members all of the proposed EaP6 except Belarus (which has observer status), as well as Russia and Turkey as full members, with the additional involvement of various international agencies and latterly the European Commission as an observer alongside a number of other countries including 7 other EU member states. A further dimension was added in 2007/8 with the launching of the Black Sea Synergy,[11] an initiative backed by the European Commission to promote regional cooperation and to coordinate among a series of existing frameworks. Bulgaria, Greece and Romania are all committed to giving the still infant Black Sea Synergy an opportunity to bear fruit.

The absence of a strong Greek voice in the discussion on the EaP creates a particular lacuna for three reasons. First, Greek policymakers and entrepreneurs have an extensive knowledge of the Balkan and Black Sea regions (including a significant diaspora across the EaP6). Second, Greek policymakers, along with their Bulgarian and Romanian counterparts, have much to contribute to the discussion of how the EaP proposals do – or do not – mesh in with the existing circles of Black Sea cooperation. Third, Greek policymakers are also much better placed than most to comment on how the EaP proposals mesh – or maybe do not mesh – with the EU's continuing enlargement policy *vis-à-vis* the western Balkans and Turkey.

What then of the reactions from six relevant target countries? Broadly speaking each government is more interested in its bilateral relationship with the EU (with varying degrees of intensity) than in the EaP as such. Their participation in the Prague Summit of May 2009 seems to have been more a matter of pragmatic acceptance than one of enthusiastic support. Moreover, domestic distractions are prominent in all of these countries.
In addition and importantly, several Russian officials have signalled their concerns about the EaP initiative. Thus on 21 March 2009 Sergei Lavrov, the Russian Foreign Minister, accused the EU of seeking to develop a "sphere of influence" in the Russian neighbourhood. Turkish politicians have had other things on their minds given the recent elections, though the potential rapprochement with Armenia is pertinent.

A critical assessment of the initial proposals

It will take some time for the EaP to be further specified and for ideas to crystallise about the most appropriate substance and tools for taking it forward. However, several criticisms can already be levelled at the initial outline of the EaP.

First of all, it has been developed without the benefit of a solid template based on previous experience, not least given the lack of workable and tested alternatives to a membership perspective. The European Economic Area (EEA) template is entirely inappropriate as a model for the proposed Neighbourhood Economic Community, given that it was devised for and sustained by the advanced market economies of EFTA, with their highly developed legal and regulatory systems. The EaP countries start from quite different bases; thus, for example, Azerbaijan and Belarus do not yet belong to the World Trade Organization (WTO). The lack of such a template may explain the existing confusion as regards the balance between the bilateral and multilateral components of the offer. Based on the EU's experience with other regions, there are good theoretical reasons for developing a multilateral approach. However, this is not something that fits easily with the *acquis* of any of the countries concerned. It is obvious that any of the EaP countries that succeeds in developing momentum in its bilateral relationship with the EU (especially upgraded to an Association Agreement) is likely to give this priority, as the Ukrainians have already indicated.

Secondly, more realism is needed about the characteristics of the EaP countries and their relationships with each other, including economically. All carry legacies of their historical hub-and-spoke links with Russia and have sparse trade and economic links with each other. They certainly do not comprise a single coherent 6-country group and it is not evident that they divide into two more coherent 3-country groups. For this reason, the current emphasis on promoting trade relationships with the EaP reflects a path-dependency on the part of the EU as regards the content of its relationships with many other countries, which needs to be avoided. Notwithstanding the importance of trade in leveraging economic growth, it is not the top priority for any of the EaP6 in current economic circumstances, and the availability of demand inside the EU for their exports will for some time be limited. Stabilisation and investment support will surely be much more urgent priorities for them.

Thirdly, given the geopolitical realities of the countries' situations, the conflict resolution issues should be more clearly in the policy frame. Indeed, the EaP only includes a light reference to cooperation regarding the common foreign and security policy (CFSP) and European defence and security policy (ESDP). These dimensions need much more attention, not least given the several conflicts awaiting resolution either among EaP countries or *vis-à-vis* in particular Russia: Nagorno Karabakh; Abkhazia; South Ossetia; Transdnistria. And in any case the EU is already partially engaged in conflict-resolution in the region, for example through the work of the EU Special Representatives for Georgia, Moldova and the Southern Caucasus. Similarly, there is only light reference to the visa and labour migration issues, despite the fact that these are priority concerns for at least some EaP countries, and despite these having been highlighted, especially by Polish proponents of the EaP.

Fourthly, more attention should be given to how the EU contribution to the transformation and stabilisation of these countries is to be coordinated with the work of other international and regional agencies or with the bilateral programmes of individual EU member states. Indeed, a number of discussions relevant to the EaP initiative have taken place inside other international agencies active in the EaP countries, such as the Council of Europe, to which all EaP6 except Belarus belong. Similarly, a "Joint Action" has been developed by the EBRD, the EIB and the World Bank to provide economic and financial stabilisation support for central, eastern and southern Europe. The EU should create synergies with the work of these other international agencies, drawing (for example) on its experiences of the Söderköping Process (initiated by the UNHCR and the Swedish Migration Board in 2001 to promote cooperation between the acceding EU member states and the eastern neighbours, i.e. Belarus, Moldova and Ukraine), just as it has lessons to learn from the way in which the framework for the western Balkans has evolved under the new RCC and the revised CEFTA.[12]

Finally, the EU's reluctance to face up to the membership aspirations of at least some of the EaP countries will continue to be a difficulty for both the EU side and the partners' sides in developing the relationships. There is virtually no support in the EU for a policy that would admit a "membership perspective" for all of the EaP6, partly because of membership fatigue but also because of uncertainties concerning the transformation processes in the countries concerned. However, if the conditionality mechanisms developed for the EaP are to work, they will need to be more carefully geared to the needs and aspirations of the target countries, given the difficult circumstances which they face. The membership question will keep on rearing its head.

All in all therefore, a good deal remains to be done to improve the focus and quality of the proposed EaP, as well as its intended deliverables.

In search of a more "joined-up" policy

The EU needs in essence to develop a more comprehensive policy – and one which joins up a variety of different segments of different policies in at least four respects:

- The EU should review its firm distinction between countries that are actual or potential candidates for regular EU membership and those that are on the other side of this line, not least because the timelines for anchored transformation and stabilisation, as well as the resolution of security issues, are so difficult to predict country by country.

- The EU should put its own house in order by aligning those of its own policies that are relevant to the region, in particular as regards CFSP, on the one hand, and the routines of "external relations" or of enlargement/pre-accession processes, on the other hand. It is critically important to manage in parallel the relationships between the EU and Russia, on the one hand, and that between the EU and Turkey, on the other hand.

- Much more attention needs to be given to how EU policy is developed in relation to the policies of other international and regional agencies and organisations towards the region.

- It is crucially important to reengage a larger number of EU member states in the development of policy, both in the sense of political attention and as regards their own bilateral and regional contacts with this or that country in non-EU Europe.

Future policy has to be situated somewhere on the spectrum between, at one end, an assumption of no (or virtually no) enlargement beyond the EU27 and, at the other end, a more permissive acceptance of potential further candidates, as and when their transformation processes take them into the category of plausible candidates. John Palmer argues, for example, for an ambitious and durable alternative framework to regular EU membership in the form of a "European Commonwealth".[13] His view is that further enlargement of the EU is improbable and probably undesirable and that a wide, ambitious and durable framework should be created by the EU with all of its European neighbours (including Russia), with shared multilateral institutions and wide-ranging functional cooperation. Though logic might favour the merits of acknowledging a "membership perspective" for at least some of the EaP6, in the short-to-medium term most plausibly Moldova and Ukraine, this may be too much for EU policymakers to swallow at the moment.

The preferred thesis underlying this paper is: (a) to keep the door open for both current and further potential candidates, depending on their processes of transformation and subject to the firm retention of pre-accession and accession conditionality; and (b) to resist the temptation to proliferate new institutional frameworks. This suggests that we should blur rather than sharpen the line between "candidates" and "potential candidates" and concentrate on thickening and deepening functional cooperation, as well as investments in political and economic stabilisation.

The way forward: functional differentiation and inter-agency cooperation

There is, however, some merit in functional differentiation among different domains of cooperation. Thus, in relation to trade, the EU should develop conventional trade liberalisation through an enlarged CEFTA process,[14] which could relatively easily be stretched to include Moldova and Ukraine, and in due course perhaps others from the EaP6 (in addition to the existing members from the western Balkans). A serious investment in making CEFTA deliver makes more sense than the creation of yet another and separate framework. Similarly, in relation to economic stabilisation and investment in the region more broadly, the EU should continue and reinforce the consortium of international agencies dealing with economic stabilisation, investment and so forth across the region, where the EU involvement has to be dovetailed with those of the EBRD and the World Bank – and not only via the EIB.

As regards the development of the rule of law, democratic processes, stable governance and human rights, the EU should clarify and develop – again on a consortium basis – the complementary roles of the EU, the Council of Europe and the OSCE. It should likewise take forward relevant areas of sectoral policy cooperation, with energy markets and energy security being obvious priorities, as the Commission has already signalled, and here again be careful to connect to both existing instruments (such as the South East Europe Energy Community, as well as the various Black Sea fora) and to partnerships with Russia and Turkey. Finally, the EU should identify ways of addressing the foreign and security policy concerns (including a "Nato policy") relevant to relationships with the EaP6 and to the subject matter laid out in the EaP proposals, in recognition that EaP policy, like enlargement policy and the previous ENP, is part of EU foreign policy.

This approach would lack the intended crisp definition of an EaP and instead replace it with a "Venn diagram" approach, which, on the one hand, allows for the development of functional cooperation with fuzzy boundaries and with clear linkages to other international and regional agencies, while, on the other hand, emphasising the necessity of tying policy into a more sharply defined foreign policy perspective. To achieve this requires the efficient harnessing of resources and experience and also the building of capacity to deliver functionally effective results. Here the European Commission has a key role to play: by developing a strategic approach to these interlinked policies (as it did in developing the enlargement policy of the EU during the 1990s); by reinforcing its own staff expertise on the countries concerned in order to deepen knowledge of them; and by keeping up the pressure on the EU member states to pay attention and to devote resources to the whole of non-EU Europe. In this context it would be counter-productive to segment the management of any version of the EaP by appointing a "special coordinator", as the Polish Government has repeatedly proposed.

Yet maybe any such approach to this group of eastern partners risks missing its objectives both as regards the needs and interests of the target countries, and as regards the EU and its member states. As so far developed the EaP, like the preceding ENP, has limited purchase on the countries concerned and has not yet made much of a contribution either to the longer-term stabilisation of the region or to dealing with short-term conflicts and crises. The French presidency-led response to the Russian-Georgian crisis of August 2008 may have mitigated tensions for a while, but the underlying problems remain unresolved. In addition the succession of overlapping initiatives towards the region have been propelled too much by the desire of this or that EU government to be in the spotlight or to be seen as the sponsor. There is disappointingly little evidence of a cumulative sense of collective and purposive EU responsibility towards the region.

Of course the EU and all member states have an interest in having a stable eastern (as southern) neighbourhood. But they have yet to find the tools to achieve this – they need either to be much more modest and low-key, recognising that to create excessive expectations is counterproductive, or they need to be more ambitious and more strategic, then investing more attention and more resources. As the EaP currently stands it falls between these two stools.

Chapter 6

Valuing our neighbours: pro-growth initiatives and the danger of exporting the wrong regulatory frameworks

Patrick A. Messerlin*

Any attempt to improve the European Community neighbourhood policy should start by recognising the extent of recent dramatic changes. Until 2004 – only five years ago – the EC was a club of countries that had enjoyed sustained growth and the luxury to develop their own domestic institutions in a relatively stable environment. The success of the first fifty years also largely depended on the fact that the EC was a fairly homogeneous entity. The ratio of the richest to the poorest EC member state was less than 2, a ratio smaller than that between the richest and poorest US states. Also, the EC found success easy as its initial ambitions were rather limited: the first serious attempt to open services markets and deal with complex regulatory issues only occurred in the early 1990s.

Dramatic changes present an extraordinary opportunity

In the 2000s, the situation changed dramatically for several reasons. First, EC ambitions became much wider, covering a whole spectrum of regulatory issues. Second, the twelve newest member states faced much greater difficulty in their own domestic development during the last century, and their growth since the Second World War has been less

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stable. In addition, the ratio of the richest to the poorest member state jumped from less than 2 to almost 8, making the EC as heterogeneous as China (see Annexe Table 1). Therefore, it is not surprising that these changes have been considered a source of severe stresses in the EC – the three rejections in referendums to new treaties, an ambivalent Turkey, the shocks of energy prices, the Russo-Georgian war and the open "revolt" of eight new member states against future EC norms on climate change[1].

In sharp contrast with this pessimistic view, these dramatic changes present an extraordinary opportunity for the enlarged EC to improve its governance and for its neighbours to do the same. But, seizing this opportunity will require a change in mindset. Until the mid-2000s, EC neighbours tended to see the EC as a source of solutions for the problems they faced. The current EC neighbourhood policy still reflects this outmoded view, failing to recognise the fact that the EC is increasingly facing the same difficulties as its neighbours, because several of its member states are not much richer than some EC neighbours.

This chapter argues that it is important to recognise that there is more than one path to convergence with EC standards and there is a need to shape a new, more pragmatic, cooperative and progressive neighbourhood policy. It concludes by way of addressing the issue of EC membership from this perspective.

The critical challenge of EC heterogeneity

In the 1990s and 2000s, the EC's systemic response to its ever-growing heterogeneity was increasing regulatory convergence, based on "the same size fits all" approach embodied in the *acquis communautaire* (the total body of EU law, hereafter the *acquis*), instead of relying on the "subsidiarity" principle. During the 1990s, the number of texts included in the *acquis* grew faster than EC GDP by one percentage point. The pace of growth was even faster during the 2000s, by more than three percentage points. Today, the *acquis* is estimated to include about 1700 regulations.

Of course, the number of regulations is not the most important issue. The crux of the matter is the extension of EC policies to cover regulation intensive issues, such as industrial standards and services. The fact that an increasingly higher share of the *acquis* is devoted to "set norms" raises a number of problems. Firstly, norms address issues that often depend on the income level of the people involved: for instance, richer people can afford to be more demanding with regard to food safety or environmental conditions. Secondly, norms often raise costs, if only because they address problems that were previously ignored. For example, less polluting engines require additional features, information requirements need additional expenses, etc. And finally, norms often require high-technology and capital-intensive products, meaning that they favour industries located in the older member states.

As a result, the richer the people in a member state are, the more often they see norms as desirable, the better they can afford cost-increasing norms, and the more readily they contribute to the production of goods and services meeting stricter norms.

This is why EC heterogeneity is so critical. The more heterogeneous a country is, the more its regulations should be designed in a way that can accommodate the various levels of domestic incomes and asymetric production patterns. This is the challenge that the enlarged EC is confronting *internally*. It is also the EC challenge in terms of its neighbours. As a result, the current EC neighbourhood policy that focuses on the convergence of EC neighbours' regulations to the EC *acquis* is outdated.[2]

The EC *acquis* and economic growth

Convergence with the *acquis* could remain an attractive option for EC neighbours if it were the key to economic success. But, the EC's own experience shows that this is not the case.[3] There is, at best, a weak relation between convergence with the EC *acquis* and economic growth rates of the new member states (See Annexe Table 2). Firstly, the growth in *regulatory* performance in the central European member states (the Czech Republic, Hungary, Poland, Slovakia, Slovenia) and in the Baltics (Estonia, Latvia, Lituania) was highest when their membership was a remote prospect. Secondly, *economic* growth differs substantially between these two groups of member states during the decade 1996-2007 whilst all of them were exposed to the *acquis* with the same intensity. The central European member states exhibit an average growth rate significantly lower (2 to 4 percentage points per year) than the average growth rate in the Baltics.

These results do not indicate that the *acquis* is a significant source of economic growth. Rather, they point to *domestic* regulations as drivers of economic progress.

Before drawing any final conclusions, it is also important to examine the impact of the recent economic crisis, especially since the Baltics have faced a much sharper drop in economic activity in 2008 and 2009 compared to the central European member states.[4] Yet, even in light of the crisis, the findings point in the same direction. First, the average growth rate of the Baltics from 1997 to 2010 ranges from 4.6% (Latvia, Lithuania) to 5.0% (Estonia) compared to 2.5% (Czech Republic) to 4.2% (Slovakia) for the central European member states. In short, the regulatory "mistakes" made by the Baltics (and their anchor Nordic members states) reduced, but did not reverse the benefits of their policies. Second, the future will be driven by the ability to "rebounce". The central European member states fare better today because they are protected from the crisis by their regulations – indeed regulations which did not lead to "mistakes", but nor did they lead to growth. Yet, what counts in the future are incentives to improve existing regulations. The current situation gives the Baltics a much stronger incentive to improve regulations. In sum, the crisis is unlikely to change the initial results – the *acquis* does not seem a significant source of economic growth, and *domestic* regulations appear to be the driver for economic performance.

This conclusion should not be surprising as the *acquis* is estimated to represent roughly one-third of all the regulations adopted by every member state. In other words, purely domestic regulations still represent the lion's share. Moreover, transposition and *implementation* of any regulation is crucial and, by nature, always domestic.[5] Better domestic regulations and/or implementation by the Baltics (compared to the central European member states) may be explained by the fact that the Baltics have taken the Nordic member states – widely recognised as among the best regulated member states – as a source of inspiration for their own domestic regulatory framework and implementation procedures.

In short, there are several paths to absorb the *acquis,* some being much more efficient than others – a conclusion consistent with what happened to the older member states, where the *acquis* did not generate deep regulatory convergence and where, contrary to the widespread view, regulatory competition among them has continued to prevail.

This suggests that EC neighbours should pay a lot of attention to the member states that could be their "anchor(s)", i.e. the model(s) for their own regulatory regime. The policies of these states should be carefully examined, and direct relations with them are at least as important as relations with the Commission (and the EC as a whole).

Following on from the above analysis, it is evident that there is an urgent need for radical reform of the EC neighbourhood policy. The new EC neighbourhood policy should be a pro-growth strategy, not a convergence policy, because EC neighbours need, above all, growth.

The trade dimension of a new neighbourhood policy

The existing preferential trade agreements (PTAs) between the EC and its neighbours are inadequate and a far cry from the intra-EC trade liberalisation agreements of the 1960- 70s. The intra-EC trade agreements were instrumental in sustaining growth in the founding member states and boosting popular support for the EC, and a similar approach will be required for an improved EC neighbourhood policy. Any new trade agreements between the EC and its neighbours should include two critical improvements.

Trade agreements between the EC and its neighbours must include all products

Current PTAs often exclude "sensitive" industrial products – often goods in which EC neighbours have a strong comparative advantage. They also exclude agriculture and fisheries, two important activities in many EC neighbours (agriculture represents on average to 14% of the EC neighbours' GDP, roughly half the industrial share). As a result, such PTAs limit growth prospects in critical sectors for the EC neighbours.

In essence, new trade agreements should cover all the products, be they industrial or agricultural. Although some say that including agriculture in new agreements would be politically impossible for the EC, this ignores the nuances of the agreements in the sector. "Agriculture" covers two very different types of products – those produced by the farmers (farm products) and those produced by industrial agro-business firms (food products). Undoubtedly, cutting tariffs on farm products traded between the EC and its neighbours would be politically difficult. Such cuts may also not be beneficial for EC neighbours' farmers as long as the EC continued subsidising the Common Agricultural Policy (CAP). As PTAs cannot discipline such subsidies, EC neighbours' farmers would face harsh competition from subsidised EC farm products in their own markets (as do Mexican farmers and subsidised US farmers). By contrast, cutting tariffs on food products would be politically easier, and it could generate investment flows into the EC neighbours, boosting their farmers' production. As such investments would be mostly undertaken by large firms, they would favour a smooth introduction of EC-compatible norms and standards – as happened within the EC itself during the 1970s and 1980s. Another sector with a pro-growth dimension is fisheries. The Common Fishery Policy (CFP) distorts the markets even more than the Common Agricultural Policy. Its subsidies induce EC fishermen to overcatch, while its quotas induce them to limit catches in order to make fishing a sustainable activity. Subsidies are granted so freely that they annihilate the expected quota impact, and make the CFP a net contributor to the depletion of certain fish species. A CFP reform *à la CAP* would make little sense without including EC neighbours.

EC neighbours should be encouraged to broaden their horizons

All the current PTAs between the EC and its neighbours are bilateral, which is not cost-effective for two main reasons. First, EC neighbours may grant preference margins to the EC that are higher than those offered by the EC to them.[6] Ironically, such preferences should be assessed as implicit subsidies from domestic consumers to the suppliers of the PTA partner. When a Ukrainian consumer buys an EC product at the world price plus the preference margin generated by the Ukrainian tariff on a product (which could have been imported from another part of the world), it gives preference to the EC supplier. When the EC neighbours apply tariffs lower than the level at which they have bound them at the WTO, this perverse effect could be rapidly magnified – each time the EC neighbour would increase its applied tariff without infringing its WTO obligations.

Improving the pro-growth EC neighbourhood policy in trade matters could start by aligning EC neighbours' tariffs to the EC moderate ones in manufacturing (by opposition to agriculture where EC tariffs are often high). This could be achieved either via a customs union or via a free trade agreement (FTA). The benefit of a customs union is to lock in the tariff policy of the EC neighbour. However, its cost is to grant the EC the power to determine the trade policy of the EC neighbour. EC neighbours may then try to recapture their lost sovereignty by an intensive use of antidumping measures (as Turkey does) or by non-tariff barriers (NTBs) deteriorating their bad records in these matters, as illustrated by the "ease of trading across borders" (see Annexe Table 3).[7]

Such behaviour is not surprising: it occurred in the EC itself. The EC's first thirty years were characterised by many NTBs, used by the member states for circumventing the relatively more open EC trade policy. This feature has not yet disappeared, as shown by the wide dispersion of the indicators on the "ease of trading across borders" among the current EC member states (see Annexe Table 3). This dispersion is another sign of the absence of regulatory convergence *within* the EC – all the more striking because it threatens the basics of customs union and internal market after fifty years of EC existence.

On balance, it seems wiser to stick to the FTA formula because shifting from tariff protection to antidumping or NTBs would hinder consumers' welfare by raising the risk of collusive markets (antidumping) or corruption (NTBs' rents). The FTA formula also has the crucial advantage of being able to force each EC neighbour to ascertain whether an open trade regime would be beneficial, rather than to rely on a problematic EC disciplining effect.

Beyond this first step, a pro-growth EC neighbourhood policy should try to achieve two more ambitious goals. First, it should induce EC neighbours to be active participants in multilateral (world) trade negotiations, and to conclude trade agreements among themselves. Economists prefer non-discriminatory liberalisation, but political pressures may induce a more complex path such as in Mexico: FTAs with the US and Canada (1994) and with the EC (2000) have led to unilateral tariff cuts vis-à-vis the rest of the world in 2009. But a word of caution is required: such an approach has minimal distortive effects only if the countries have moderate or low tariffs vis-à-vis the entire world. Second, such widening horizons should not prevent a pro-growth EC neighbourhood policy to increase EC funding of trade facilitating infrastructures (customs, borders points, etc.) that EC neighbours may find difficult to finance. It could consist of "contracts" between the EC and its neighbours – the EC providing funds for well-defined objectives that EC neighbours are committed to deliver, with both parties agreeing on a clear monitoring procedure.

The "behind-the-border" dimension of a new neighborhood policy

The "behind-the-border" dimension covers a much wider set of issues than trade. It ranges from opening market access in services (45 to 72% of the GDP of the EC neighbours) to "norm-setting" regulations for the many emerging non-trade concerns.

Quantitative information on these issues is scant. A crude view can be drawn from the World Bank "Doing Business" indicators capturing the global friendliness of the country's regulations towards business, the cost of building and the capacity to raise capital and the transparency in corporate deals (see Annexe Table 4). Analysis of these indicators suggests three observations, some of which are unexpected and surprising. Firstly, a number of EC neighbours (the Balkans, east Europe, central Asia and Mediterraneans) do not fare well by international standards. Secondly, the EC as a whole looks no better than some EC neighbours (EFTA or Gulf countries). Last but not least, there are huge variations in performances between the member states: for example, recent member states (such as the Baltics) often exhibit better regulatory performance than early member states, such as founding members, and these founding members in turn sometimes lag behind in general, despite the fact that they have the longest exposure to the *acquis*.

The two last results are crucial when designing new agreements between the EC and its neighbours. They reinforce doubts about the benefits that EC neighbours could get from a *systematic convergence* to the existing *acquis*. And they strongly suggest two broad groups of actions to be taken: first, EC internal reforms of the existing *acquis;* second, an approach based on "mutual evaluation" and appropriate conditionality.

The need for internal EC reforms of the acquis

The principle "adopt the *acquis* first, reform it later" was not too damaging for candidate member states, such as Britain or Sweden, rich enough and endowed with a domestic regulatory regime strong enough to cope with the inefficiencies of the *acquis*. But it is a recipe for failure and disillusionment for EC neighbours that are relatively poor (hence the need to boost their growth as much as possible) and that have a weak domestic regulatory regime. As explained above, it is even a source of problems for the current member states that have income per capita close to those of the EC neighbours, and that have a still too weak domestic regulatory regime.

Reforming the *acquis* means making it more transparent and aware of its benefits and costs. First, transparency should aim at allowing the EC neighbours (and the Europeans) to keep, at a low cost, a precise record of the EC *acquis* at any point of time – something impossible today. The best way would be to make the *acquis* easily accessible is an electronic database systematically "consolidating" texts, i.e. directly integrating any new adopted provision(s) in existing texts. Each member state should also set up a similar electronic database linking their own legal texts to the *acquis*. This is key for EC neighbours that mostly deal with a few member states, and need to find "anchor" member states for building up their own regulatory regimes.

Assessing the benefits and costs of regulations requires an in-depth review of the *acquis*. Such efforts have started with the strategic reviews on Better Regulation.[8] But, they have been slow, and so far, have not addressed two key issues. First, they have not tried to make a distinction between regulations that are dominantly pro-growth, and those that are mainly setting norms (with their potential cost increases). A crude attempt to answer this question suggests a huge imbalance in favour of the norm-setting regulations that would represent almost 80% of all the Directives currently in the *acquis*.[9] Second, there is the constant need to check whether it would not be possible to achieve at lower costs the norms set up by the existing regulations. Answers to both questions require frequent and thorough "regulatory impact assessments" (RIAs). The current RIAs require institutional improvements[10] and are very limited from an economic point of view.[11]

A two step approach: mutual evaluation and conditionality

Introducing the behind-the-border agenda in new agreements between the EC and its neighbours requires the formulation of a two-step approach along the following lines. Firstly, regulatory convergence to EC *acquis* would be considered only after having checked that the mutual recognition of existing national regulations would not be sufficient (possibly conditional on some improvements). Such an exercise is in line with the "mutual evaluation" of the regulations defined by Article 15 of the Services Directive. Secondly, if regulatory convergence is necessary, it could be done by adopting, as quickly as possible, pro-competitive provisions of the EC *acquis,* with EC financial support for implementation, if necessary. In case of norm-setting provisions, EC neighbours should be allowed to enforce such norms conditionally to a certain level of income *per capita* (or to any other appropriate criterion) even if that means a long delay before the implementation by the EC partner of such a provision.

Concerning the norm-setting regulations, one shall make a distinction between the norms per se and the agencies to be established for defining or monitoring the norms. For instance, adopting a safety norm at the same level than the one prevailing in the EC may be conditional to the income *per capita* (or any other appropriate criterion). But, this should not delay the establishment of the independent agency that would monitor such a norm in the future (and possibly a less stringent norm beforehand). Such agencies are critical. Badly conceived, they can hinder technical progress (as illustrated by the Ukrainian agencies in charge of norms) or they can hide domestic problems (as illustrated by food safety episodes in the older member states, such as “mad cow” disease). Last but not least, delaying the creation of well-functioning agencies is even more costly because it often takes a long time to establish agencies truly independent from both the government and the main market operators.

Such an approach has been used for assessing the 2006 Morocco-EC air agreement . Its main results are briefly reported here for the sake of illustration. Out of the 32 provisions included in this agreement, only 5 are clearly pro-competitive, hence should be implemented rapidly. Sixteen norm-setting regulations should be analysed further because they bring unclear net benefits to Morocco, and they should be implemented under some conditions, in the medium term at the earliest. The main benefits to be expected from these 21 regulations flow from the independent agencies to be established. Finally, 11 norm-setting regulations are likely to bring net costs to Morocco for a long period of time, and are unlikely to be affordable for this EC neighbour before then.

The behind-the-border agenda deserves two final remarks. First, the mutual evaluation and the conditionality approach could also be introduced within the EC itself (as indeed it is required by the Services Directive). This is due to the fact that the twelve newest member states have incomes per capita significantly lower than those of the older member states. Second, as services may require infrastructure that the EC neighbours could not fund (or not alone) such as airports, ports, roads, energy or health logistics, etc., the behind-the-border agenda requires large-scale development of EC aid and financing capacities.

The question of EC membership

So far, this chapter has not raised the question of EC membership. The key reason is that this issue has become so emotionally loaded in the member states and in candidate countries that any rapid answer to this question – be it a yes or a no – is almost certain to bring more problems than solutions, both in the EC and in the candidate countries.

EC membership refers to European values which are of two very different kinds. There are values that have, in principle, little to do with growth, such as democracy and the rule of law, the relation between religion and state, the status of women, etc. Asking for a rapid convergence in these matters is illusory, to say the least. Europeans should remember that it took them a long time to conquer these values, and that robust progress has always relied on domestic forces. They should support the people defending such values in their EC neighbours in unflinching ways, but they cannot seek to introduce these values in a society from the outside.

And there are the European values mirrored in norms embodied in goods and services that depend on incomes and tastes. Such norms may lead to higher incomes (this is the assumption behind the current EC convergence policy) but they are also generated by higher incomes. Focusing on economic growth would accelerate or reinforce such European values. Europeans should recognise that they would have rejected many of today's EC norms two or three decades ago, when their incomes were closer to those of their neighbours today. In addition, asking EC neighbours to converge with such EC norms and rules without a voice in their design runs the huge risk of limiting the sovereignty of these neighbours, of denying them their own horizons of influence (with their indirect benefits for the EC) and ultimately of eroding the internal credibility of their governments.

Time to value our neighbours

In many respects, the EC situation today vis-à-vis its neighbours reminds one of the situation that the US faced with Europe in the 1950s. It is useful to reflect on the decisions taken by the US at that time. First, the US took the risk of supporting the nascent EC although it was not part of it and had no preferential economic agreement with any founding member state – the exact opposite of the current EC approach to its neighbours.[13] Second, the US could have pushed Britain to join a US-Britain common economic area. Rather, it took the view that Britain as a member of the EC would be much more influential in shaping a modern European economy. Finally, the US reduced the risks intrinsic to these two decisions by investing a lot of money, people and ideas in European countries. Investments in people and ideas were often done via private thinktanks, not via government-sponsored thinktanks or NGOs (as is often the case in the EC approach today). The US approach was so successful that, sixty years after the Second World War, a vast majority of Germans would still turn to the US rather than to France, would they have to choose between the two countries.

Transposed to the EC, the US approach suggests that the EC should support free trade agreements between its neighbours without having a preferential agreement with them, invest much more heavily in pro-growth initiatives in its neighbours, take the risk of its largest neighbours becoming leaders in the Eurasian or Middle East economic integration processes, and invest patiently in people and ideas. In short, far from a retreat from "European values", the pragmatic, progressive and cooperative approach described here would maximise the chances of making such values truly attractive to EC neighbours.

Annexe

Table 1. Economic heterogeneity

	EC Member States	EC neighbours: EFTA Turkey	EC neighbours: West Balkans	EC neighbours: Med. Gulf coun-tries	EC neighbours: East Europe Central Asia	US States	Chinese Prov-inces
Richest	*70014*	*47551*	*13232*	*68696*	*11861*	*67048*	*13735*
Poorest	*9353*	*7786*	*2362*	*1691*	*1431*	*27290*	*1349*
Ratio	*7.5*	*6.1*	*5.6*	*40.6*	*8.4*	*2.5*	*10.2*

Sources: World Bank [2008]. For the Chinese provinces and the U.S. States, Messerlin [2007]. The heterogenity index is calculated as the ratio of the GDP per capita of the richest country (province) to the GDP per capita of the poorest country (province). GDPs per capita are provided on a power purchasing parity basis.

Table 2. Comparing regulatory and economic performances

	Regulatory performances (a)					Economic performances (b)			
	1989 1991	1992 1995	1996 2001	2002 2007		1989 1991	1992 1995	1996 2001	2002 2007
	1	2	3	4		5	6	7	8
EC Member States									
Central Europe	1.5	3.4	3.6	3.7		-5.2	1.8	3.7	4.8
Baltics	1.1	3.1	3.4	3.8		-2.4	-9.5	5.8	8.7
Bulgaria, Romania	1.0	2.4	3.1	3.5		-7.5	0.0	0.0	6.0
Eastern Europe and Central Asia									
Russia	1.0	2.8	3.0	3.1		-2.1	-10.1	2.3	6.8
Ukraine	1.0	2.1	2.9	3.1		-3.5	-14.8	0.0	7.4
Belarus	1.0	2.1	1.7	1.9		1.3	-9.8	6.1	8.5
Caucasus	1.0	2.0	2.8	3.1		-6.6	-16.2	6.5	13.4
Central Asia	1.0	2.2	2.6	2.7		-3.3	-9.4	4.6	8.3
West Balkans									
Croatia	1.9	2.7	3.2	3.4		-9.9	-1.8	3.6	5.0
Others	1.6	2.0	2.4	3.0		-6.7	-9.7	6.3	5.1

Source: EBRD [2008] Author's calculations [Messerlin 2008]. Notes: [a] Figures show the level of regulatory performances based on the simple averages of six indexes: enterprise reform, small and large privatisation, price and competition, forex and trade liberalization, competition policy. [b] Figures show the average annual growth of the real GDP. The "Central Europe" EC Member States are the Czech Republic, Hungary, Poland, Slovakia, Slovenia. See Messerlin, P. 2008. The EC neighbourhood policy: An economic review. Journal of International Trade and Diplomacy. Volume 2, No. 2. Fall.

Table 3. Assessing preferential trade agreements: the EC and its neighbours

	Average industrial tariff (a)		*Non tariff barriers (b)*	*Average agricultural tariff (c)*	
	applied	*bound*		*applied*	*bound*
	1	*2*	*3*	*4*	*5*
A. The EC and the cohorts of ECMS (d)					
EC27 (all ECMS)	*4.0*	*3.9*	*32.2*	*15.0/24.2*	*15.1/NA*
EC1958	*same*	*same*	*27.8*	*same*	*same*
EC1973	*same*	*same*	*25.3*	*same*	*same*
EC1981	*same*	*same*	*52.4*	*same*	*same*
EC1995	*same*	*same*	*10.5*	*same*	*same*
EC2004	*same*	*same*	*50.9*	*same*	*same*
Baltics	*same*	*same*	*21.9*	*same*	*same*
EC2007	*same*	*same*	*55.8*	*same*	*same*
B The EC neighbours					
EFTA	*1.5*	*2.9*	*25.8*	*49.3/na*	*88.8/na*
Turkey	*4.8*	*16.9*	*59.0*	*46.7/na*	*60.1/na*
Balkans	*4.2*	*5.8*	*97.0*	*10.6/na*	*11.5/na*
Caucasus	*5.8*	*-*	*151.2*	*11.8/na*	*-*
East Europe	*9.5*	*-*	*154.9*	*15.9/na*	*-*
Ukraine	*5.0*	*4.4*	*131.0*	*23.0/na*	*10.9/na*
Central Asia	*8.6*	*-*	*165.6*	*13.0/na*	*-*
Gulf countries	*4.7*	*21.3*	*31.6*	*7.3/na*	*30.6/na*
Mediterra-neans	*13.3*	*19.1*	*57.1*	*40.0/na*	*57.8/na*

Sources: WTO Trade Profiles [2008]. World Bank Doing Business [2008]. ECMS: EC member states. Notes: [a] Ad valorem tariffs only. The absence of bound tariffs for Caucasus, East Europe and Central Asia is due to the fact that few of these countries are WTO Members. [b] Average ranks (by cohort, group of countries or country) for the Doing Business indicator "trading across borders". [c] For the EC cohorts, the first figures are ad valorem tariffs, the second figures aggregate ad valorem and specific tariffs (or "na" when the ad valorem equivalents of specific tariffs are not available). The absence of bound tariffs for Caucasus, East Europe and Central Asia is due to the fact that very few of these countries are WTO Members. [d] The cohorts of ECMS are defined by the year of accession, except the cohort EC1981 which includes Greece (accession in 1981) Portugal and Spain (accession in 1986). The Baltic countries are shown separately, but they are also included in the calculations for the EC2004 cohort.

Table 4. Opening the "behind-the-borders" agenda

	Doing Business indicators (a)				*Market size at (b)*	
	ease of doing business 1	*dealing with licences* 2	*registering property* 3	*protecting investors* 4	*current USD* 5	*PPP USD* 6
A. The EC and the cohorts of ECMS (c)						
ECMS (all ECMS)	*35.0*	*52.6*	*68.2*	*62.8*	*32.5*	*22.6*
EC1958	*36.3*	*40.2*	*87.8*	*72.4*	*18.4*	*12.0*
EC1973	*6.0*	*54.4*	*28.2*	*9.9*	*6.4*	*4.0*
EC1981	*56.5*	*60.2*	*59.3*	*91.5*	*3.7*	*2.8*
EC1995	*20.2*	*34.0*	*22.5*	*81.0*	*2.1*	*1.3*
EC2004	*60.8*	*111.2*	*65.0*	*64.6*	*1.7*	*2.1*
Baltics	*27.0*	*58.2*	*30.7*	*69.8*	*0.1*	*0.2*
EC2007	*46.5*	*95.4*	*100.00*	*38.0*	*0.3*	*0.5*
B. The EC neighbours						
EFTA	*16.3*	*45.8*	*11.0*	*102.2*	*1.7*	*0.9*
Turkey	*59.0*	*131.0*	*34.0*	*53.0*	*1.0*	*1.2*
Balkans	*101.7*	*163.9*	*93.3*	*101.3*	*0.3*	*0.2*
Caucasus	*31.8*	*107.3*	*7.0*	*34.8*	*0.1*	*0.2*
East Europe	*122.7*	*175.1*	*62.6*	*97.6*	*2.7*	*3.8*
Ukraine	*145.0*	*179.0*	*140.0*	*142.0*	*0.3*	*0.6*
Central Asia	*86.6*	*151.1*	*51.3*	*67.1*	*0.3*	*0.4*
Gulf countries	*28.1*	*56.0*	*13.2*	*45.3*	*1.5*	*1.1*
Mediterraneans	*104.7*	*126.1*	*114.9*	*83.0*	*1.2*	*2.0*

Sources: WTO Trade Profiles [2008]. World Bank Doing Business [2008]. ECMS: EC member states. Notes: [a] The "ease of doing business" indicator reflects the global friendliness of the country's regulations towards business. "Dealing with licences" focuses on the regulatory costs of building (land and building amount for half to three-quarters of the wealth in most economies), "registering property" on the capacity to raise financing opportunities via collaterals, and "protecting investors" on transparency and trust in corporate deals. High ranks in these indicators mean high regulatory costs—hence serious obstacles to economic growth and high incentives to corruption. Ranks by cohort of ECMS or group of EC neighbours are GDP-weighted averages. [b] Percentages of world GDP [c] The cohorts of ECMS are defined by the year of accession, except the cohort EC1981 which aggregates Greece (which acceded in 1981) Portugal and Spain (which acceded in 1986). The Baltic countries are shown separately, but they are also included in the calculations for the EC2004 cohort.

Chapter 7

Managing the global trade agenda

Sophie Meunier and Wade Jacoby

The current financial crisis did not trigger a sudden realisation in Europe that globalisation could indeed have negative, deleterious consequences. For more than a decade, globalisation has been the source of many worries in Europe, where it is more often perceived as a danger than as an opportunity.[1] Some Europeans see a threat to their jobs, others to their broader social welfare and others again to their entire way of life. At the same time, globalisation promises opportunities, especially to those actors who can serve new or existing markets with cheaper inputs. This blend of threat and opportunity – combined with a sense that globalisation may simply be too powerful to be resisted outright – has led many European policymakers to speak of what we term "globalisation with adjectives." Typically, the adjective injects a note of caution that suggests the embrace of globalisation is a conditional one – whether globalisation is to be "humanised," "tamed," "harnessed," or "managed." In this chapter, we adopt the term "managed globalisation" as a shortcut for all political attempts to make globalisation more palatable.[2]

The European Union has often been vilified as a Trojan horse that helps bring globalisation into the heart of Europe. Others, however, have heralded the EU as Europe's best defense against the negative effects of globalisation. Over the past decade, European voters and politicians have increasingly demanded that the EU actively and offensively "manage" globalisation instead of just passively accepting it. With the current financial crisis spreading like wildfire across the Atlantic, such demands for managed globalisation are all the more pressing.

Has this idea of "managed globalisation" been only political rhetoric for domestic political consumption, or instead has it been a source of real policies with international consequences? One possibility is that globalisation with adjectives is a purely rhetorical device. Political leaders often try to imply that citizens are safer in their hands than they would otherwise be because politicians are "managing" globalisation, instead of merely letting it happen. It shows the voters that elected officials are firmly in control, that they still have a margin of maneuver and that they have not abdicated policymaking in the face of external forces.

Against mere political rhetoric, however, we argue that the will to manage globalisation has indeed been a primary driver of many major policies undertaken by the EU in the past decade. The EU has attempted to implement policies designed to manage globalisation by using four main mechanisms that we analyse elsewhere: exercising regulatory influence, empowering international institutions, enlarging the territorial sphere of EU influence and redistributing the costs of globalisation.[3] In this chapter, we focus specifically on how the EU has defined and operationalised these broad functional mechanisms in the field of trade. Some mechanisms are meant to ensure that globalisation happens on European terms, with other countries conforming to Europe's ways and standards. Other mechanisms help ensure that the external challenges and pressures brought about by globalisation have as little negative, disruptive effect on European citizens as possible. These mechanisms are neither entirely novel, nor are they necessarily effective. But we suggest that they provide the contours of an approach to globalisation that is neither ad hoc deregulation, nor old-style economic protectionism. Perhaps learning the lessons about the EU's experience in managing trade globalisation could be useful as the world embarks on a vast experiment in managing financial globalisation.

Building a set of constraining trading rules

"Managing" means altering the existing course of things and reorganising them for a purpose. In trade, this reorganisation has involved, above all, the establishment of sturdy, empowered international institutions with clear rules of the game and an institutional architecture to monitor those rules. The central idea is that rules are better than no rules, that general rules are better than ad hoc rules, and that the EU is well placed to assert its rule preferences and expertise vis-à-vis the rest of the world. This fits with the EU's global strategy of developing its own regulatory power in order to decisively shape global governance.

Since the signing of the Uruguay Round in 1994, the EU has strongly supported the creation of rules for settling trade-related disputes in the WTO. This pattern holds even when many such disputes have been settled against the EU, especially in the early days of the system, and many criticisms were being voiced inside Europe. Managing globalisation in trade has meant making a codified set of rules for reporting violations, adjudicating disputes, and implementing resolutions in order to facilitate trade liberalisation in the world.[4] Today, the WTO's Dispute Settlement Body plays the well-accepted role of arbiter of differences. It gives the losing party the opportunity to bring its regulations in conformity with the WTO agreements and, if not, authorises the plaintiff to impose retaliatory sanctions. This trade rule of law reduces the need for unilateral actions and trade wars, and it contributes to the stability of the system, especially given the twin pressures exerted by a growing number of goods and services being traded by a growing number of countries.

The trade policy agenda of the EU currently involves improving the system further, making it even more transparent and effective. In parallel to the ongoing Doha round of multilateral trade talks, the EU has been advocating changes to the dispute settlement mechanism to make the rules even more constraining, including more permanence in the personnel of the arbitration panels, greater transparency and greater access to the system by the developing countries through training and assistance.

One unanticipated consequence of this establishment of strong rules of the game is that these rules also enabled globalisation to progress even further. Indeed, the trade barriers that did not conform to the new, clear, multilateral rules are being torn down under the new regime. As a result, a central paradox is that the same global institutions the EU often seeks to strengthen have come under fierce criticism for accelerating globalisation as opposed to managing it, and therefore have become the target of attacks and have lost political legitimacy.

Another consequence is that while trading rules are now legally binding at the international level, they may not be rules preferred by the EU. This particular strategy for managing globalisation may backfire when it is too successful. The ongoing debate over genetically modified organisms

(GMOs) is a case in point. The EU might now be subjected, by virtue of its membership in the WTO, to rules that its citizens consider neither acceptable, nor desirable.

The EU is also trying to manage globalisation in trade by widening the trade issues subject to rule-making. Since world trade is regulated by powerful international rules applying to a very large, ever expanding number of countries, the more issue-areas fall under the aegis of the WTO, the more "managed" globalisation will become. Therefore an important objective of the EU position in trade negotiations in the past decade has been to bring as many issues as possible into the fold of the WTO.

This agenda of "trade and issues" was launched in the mid-1990s, with a specific focus on trade and trading conditions, trade and environment, trade and labour laws and trade and culture. The EU championed in particular the "Singapore issues," addressing and establishing rules for the conditions under which trading takes place (competition policy, transparency in government procurement, trade facilitation and investment), but it failed in imposing its viewpoint upon the other WTO members, especially the developing countries, which had acquired more voice than ever in multilateral trade negotiations and insisted on retaining control over these key sectors of their economy. The EU, however, is still pushing for the Singapore issues in bilateral agreements.

Promoting multilateralism

International institutions with muscle can help manage globalisation only if their constraining rules apply to the largest possible number of countries. Therefore, the EU has insisted on expanding the number of members in an inclusive WTO as part of its policy of managed globalisation. The more members, the more countries subjected to the rules, and therefore the less anarchy in the trading system.[5]

The number of countries making, and subject to, the rules of the multilateral trading system has greatly expanded over time. From 23 original founding members, the GATT had 128 members at the time of its demise in 1994. Today, 153 countries are members of the WTO, and about 30 are involved in negotiations to join in the future. From the time of the creation of the WTO in 1995, the EU has been a champion of enlarging it to more countries, for instance pushing for the inclusion of China (member since 2001) and Russia (still pending) into the world trading system. The EU has also been instrumental in calling for the inclusion of countries such as Cambodia, Saudi Arabia, Vietnam and Ukraine in the WTO.

This broad strategy is central to EU efforts to manage globalisation, but it clearly has its risks: the more countries become members of the WTO, the more diluted the EU's own influence within the institution and over the outcomes of international trade negotiations. Besides, the more member countries there are, the more they can band together against European interests in negotiations. Up until the end of the Uruguay Round in 1994, most of the important decisions were actually negotiated by the Quad (EU, US, Japan, Canada), when not by the EU and the US exclusively. As the Doha Round is proving, many developing countries, such as India and Brazil, have voiced their new found strength and are intent on not letting the US and the EU run the show as they did in the previous GATT rounds.

In addition to expanding the number of countries subjected to international trade rules , the EU has also insisted on prioritising multilateralism, even to the exclusion of other types of cooperation. This is a controversial policy that has recently given way to a new wave of bilateral negotiations. Under former trade commissioner Pascal Lamy's tenure (1999-2004), the EU informally imposed a moratorium on new bilateral free trade agreements until the end of the Doha Round.[6] This was a strong signal to the rest of the world that the EU was committed to making multilateralism work. This promotion of multilateralism stood in contrast to the US policy of "competitive liberalisation" during the same time, which was based on the premise that bilateral trade agreements with a host of small economies would help liberalisation at the multilateral level by unlocking stalemated negotiations (even if some of these American FTAs were clearly politically motivated, such as those with Morocco, Dubai and Bahrein, post September 11).

This EU moratorium had real consequences on the policy and negotiating strategies available to the EU during the Doha Round. Above all, because the EU's limited its outside options at a time when the US and many countries in Asia negotiated a flurry of bilateral deals, it fundamentally shaped the EU's negotiating position in the multilateral negotiations. Supporting multilateralism in the name of managing globalisation also put head-to-head two competing interests of the EU: on one hand, defending its narrowly defined economic interests (such as in the case of agricultural subsidies, which are under attack by a multitude of members); on the other hand, casting the net of global rules over a wider number of countries, therefore harnessing globalisation more tightly. The problem for the EU is that it does not seem to have prioritised one set of interests over the other, as the consecutive meetings in the Doha Round have shown. In principle, multilateralism should have a liberalising effect on the world economy, as long as the clash of interests it reveals does not lead to the ultimate collapse of multilateral trade talks and a retreat to national or regional protectionisms.

Lamy's successor, former EU trade commissioner Peter Mandelson, reassessed the direction of the EU trade policy in the Commission's October 2006 communication, "Global Europe: Competing in the World." This document renewed and redefined the objectives of EU trade policy in the years to come.[7] "Global Europe" insisted on the "primacy", not exclusivity, of multilateralism, thereby ending the moratorium on bilateral trade agreements. Therefore, the EU has now launched bilateral and regional trade negotiations with ASEAN, South Korea and India, as well as an update of the political agreement started with the Gulf Cooperation Council 17 years ago. This policy is now pursued by Mandelson's successor, current EU trade commissioner Catherine Ashton.[8]

Extending the EU's territorial sphere of influence

In addition to negotiating the collective rules of globalised trade at the international level, the EU's managed globalisation agenda also includes trying to extend its territorial sphere of influence. This happens in at least three ways. First, the EU can enlarge, admitting new states that must, by definition, conform to its rules.[9] Second, it can try to establish a heightened level of influence on non-member states, which, in practice, has generally meant geographically proximate ones. Finally, and more ambitiously, it can try to export its model to the rest of the world.[10] After all, the EU is itself an experiment in managed globalisation, with a four-decade long experience in market liberalisation combined with regulatory harmonisation.

By expanding its territory through enlargement, the EU "subtracts" new countries from the unadulterated reach of globalisation and therefore expands its control and influence. In the relatively long process of preparation for EU membership, the twelve CEE states that joined in 2004 and 2007 were managed in systematic ways. This strategy has yielded a number of short-term benefits for the old EU15.[11] But it has obvious geographical/geopolitical limits. The EU cannot take on states as members just because it would like to reorder some of their international and domestic economic policies. And even though the EU is indeed trying to engineer some degree of "convergence without joining" with the countries subject to its new "Neighborhood Policy," recent comparative data suggest that anything short of the promise of full membership tends to generate far less "compliance" with EU targets than does the offer of full membership.

In the longer term, then, another element of EU strategy has been to foster in other regions regional economic integration that is loosely in the EU's image, for example, encouraging states in other regions to negotiate as a single entity. This has been the rationale behind the long, drawn-out negotiations with MERCOSUR for an association agreement between the two regions, as well as the Commission's efforts towards the creation of a regional body to promote free trade in the western Balkans. Once again, the hope is that the more rules apply to more members (and the more detailed and extensive these rules), the more efficient Europe becomes in managing globalisation.

A related part of this strategy has been to conclude trade agreements between the EU and other regions. The EU offers access to its market as a bargaining chip in order to obtain changes in the domestic arena of its trading partners – from labour standards to human rights, from democratic practices to the environment. This conditionality enables the EU to leverage its trade power in exchange for a tamer, more managed competition from many developing economies. It is also a way of using trade policy to pursue foreign policy, sometimes out of the limelight and behind the back of the member states.

In addition to the obvious geographical limitations, the effectiveness of using the export of the EU model as a mechanism to manage globalisation in trade is limited in the short run. The objective of managing globalisation is, to some extent, a long-term objective. Even if the EU were to succeed in implementing all of its strategies, the payoffs would come in the future. It will take a long time for the export of the EU regional integration model to be implemented and affect positively the lives of EU citizens. In short, enlargement is an effective management tool but has limited future scope, while the Neighborhood Policy is not nearly as effective. Finally, promoting regionalism abroad is likely to pay off only in the longer term if it pays off at all.

Redistributing the benefits and costs of globalisation

Finally, managing globalisation means not only building a framework of rules within which exchange can occur, but also redistributing its costs and benefits. These strategies can play a crucial role in sustaining public support for economic openness. Some steps are purely intra-European. For example, Lamy introduced the idea of a globalisation adjustment fund before he left the Commission. At the Hampton Court EU summit in December 2005, after a wave of layoffs by multinational companies in Europe and especially in France, the 25 EU leaders, led by French President

Jacques Chirac, agreed to accompany trade liberalisation with redistribution in the form of a "globalisation fund", in order to compensate for the negative effects of globalisation. The European Globalisation Adjustment Fund, started in January 2007, is designed to help train and relocate about 50,000 European workers a year whose jobs are lost to the dynamics of global trade. On paper, the fund is an instrument for managing globalisation in the face of globalisation pressures. It provides retraining, job search assistance and the promotion of entrepreneurship with an annual potential budget of 500 million euros. However, the fund is for the moment little more than a symbolic gesture. Less than 100 million euros have been disbursed and about 15,000 have been assisted through the fund since it entered into force in 2007.

The strategy also contemplates redistribution at the global level. That means, for instance, using non-reciprocal trade benefits to improve the economic development of the least advanced countries. The stated cornerstone of the EU's trade policy since the launch of the Doha Round in 2001 has been to distribute fairly the benefits of globalisation, using trade liberalisation to improve the economic development of the least advanced countries. This explains some of the EU trade initiatives under Lamy's tenure, such as the 2001 "Everything But Arms" policy, the "Access to Essential Medicines" policy designed to improve the affordability of medicines in developing countries, and the new Generalised System of Preferences (GSP) for developing countries adopted by the EU in 2005. These initiatives were an essential component of the doctrine of managed globalisation, even though they sometimes appeared to run counter to the immediate interests of the member states – for instance those who have a large pharmaceutical industry.

The strategy of ensuring the redistribution of the costs and benefits of globalisation has hit some contradictions in the current Doha negotiations. The main problem of the European commitment to using trade to foster development is that it conflicts with certain trading interests – especially in agriculture. But conflicts of interests have also emerged with respect to the access to medicine initiative, for instance, since it affects many European pharmaceutical companies concerned with intellectual property issues, who might have preferred a more aggressive defense of their trade interests.

Finally, it is not clear that the EU's efforts to devise special trade regimes in favour of the developing countries have paid off in terms of bargaining power in multilateral trade negotiations. From a rational perspective, one could understand the strategy of redistributing the benefits of globalisation to the poorest countries as a way of creating allies in a multilateral system, where an increasing number of actors have a voice. But this does not seem to have happened in the Doha Round. At the Hong Kong meeting in December 2005, as at the Geneva meeting in July 2006, the EU found itself accused and isolated.

Back in full force: managing globalisation for Europe

This chapter has detailed four ways in which EU efforts to manage globalisation go beyond the undeniable rhetorical uses to which the term lends itself, even if the success of this strategy has been limited in practice. First, management entails an effort to set regulatory standards in the international economy, including outside of Europe. Second, management includes an effort to empower international organisations. Third, it involves various strategies for enlarging the territorial sphere of EU influence. Finally, management can entail efforts to redistribute the costs of globalisation.

But each segment of this agenda also makes the EU vulnerable. The EU must accept that it will lose trade cases, an outcome that tends to erode the legitimacy of their efforts to promote further institutionalisation. The EU efforts to bring more states into international trade organisations also tend to undercut their own voice inside those organisations. Its commitment to multilateral approaches left the EU with a large deficit to overcome when the US moved aggressively towards more bilateral trade agreements while the EU long kept a moratorium on such deals. The enlargement tool has few places left where it can plausibly be deployed, and the EU's redistribution of costs to, in some cases, its own material detriment has not (yet) really bought it new allies in multilateral forums.
Broadly, the central paradox is that the same global institutions the EU often seeks to strengthen have come under fierce criticism from European actors not only for not managing globalisation but for even accelerating it in some cases. As these organisations become the target of attacks, they lose political legitimacy inside Europe – a trend for which the WTO may be the best example. Moreover, we have seen an inherent, risky contradiction: the management of globalisation through trade can be successful only as the greatest number of countries and issues are covered; but more countries increases the risk that management will more likely go in directions uncongenial to EU interests – unless the EU can find a way to impose its regulations on the rest of the world.

All of these tensions are sobering as the financial crisis poses a stiff challenge to all capitalist economies. Interestingly, the term "managed globalisation" was used somewhat less under Lamy's successor, Peter Mandelson, and the idea moved from being a primary motivator of EU policies to the back burner in the past three years. Therefore when the financial crisis hit in the fall of 2008, the initial instinctive reaction in most European countries was not one of immediately asking the EU to step up its efforts to manage globalisation. Nor was it to appeal to the WTO and bring a quick settlement to the Doha round in order to provide a boost to world trade and a stimulus to the world economy. But, more than a year of ongoing financial and economic crisis has brought back the idea, in full force, of the EU as a manager of globalisation, which the current EU trade commissioner, Catherine Ashton, has embraced.

The widespread perception that the crisis is one of a failure of regulation – including and perhaps especially those of non-European actors like the United States – is likely to increase the legitimacy of the concept in the eyes of many European voters, including many who defeated the proposed European constitution and are wary of Brussels' perceived repeated encroachments on national sovereignty. Its decade-old experience in trying, successfully or not, to manage globalisation may give the EU a comparative advantage in the current period. "Managed globalisation" may indeed be coming back in full force as a possible savior of the current era of globalisation from its worst excesses.

Chapter 8

Defensiveness and fragmentation in trade policy

Fredrik Erixon and Razeen Sally

European trade policy finds itself in an unenviable position; it is stuck in an agenda that does not yield the desired results. Its core trade agenda for the past ten years has been strikingly unsuccessful. With the exception of the EU's eastward enlargement in 2004, the record of completed trade agreements or trade reforms is thin and mostly covers countries of little commercial significance. Nor does it seem likely that its current agenda, which was set out in 2006 and travels under the name of *Global Europe,*[1] will change this record significantly.

More importantly, protectionism is on the rise. The global economic downturn has spawned protectionist sentiments in general, and specific policies to prop up ailing industries and firms. That applies to Europe and its trading partners. It puts EU trade policy on the defensive, imposing greater constraints on the EU's ability to open up third-country markets through trade negotiations. It also causes problems at home; the economic recession can give cover for protectionist measures that have been brewing in the EU in recent years. Calls for action are mostly directed against China. They are meant to correct a ballooning EU-China trade deficit. They are also meant to prevent relocation of production away from Europe as a result of measures to reduce carbon emissions in Europe. As the world's number one destination for outsourced manufacturing production, China is the main target for such concerns.

This chapter is a stock-take of EU trade policy and its likely direction in the short-to-medium term. It points to two serious challenges: emerging protectionist threats; and the fragmentation, or disintegration, of EU trade policy.

Europe's trade agenda: from multilateral to bilateral

For most of the post-war era, European trade policy has followed three tracks: multilateral, preferential and unilateral. Europe has always been a key actor in the multilateral trading system, and in the last few decades multilateral trade agreements have formed the backbone of EU trade-policy ambitions.

Its preferential trade policy was long directed towards neighbours outside the Common Market (especially countries in the European Free Trade Area), and the former colonies of Britain and France. Important changes have emerged, with Europe seeking stronger trade ties with other regions. Some have been close to home (as with the free trade agreements signed with Central and Eastern European countries in the 1990s); others have been farther away.

There have also been important unilateral trade reforms; reforms opening up the European market outside the realm of typical trade negotiations. The bulk of these reforms have been essentially "domestic", intended to reduce intra-European barriers to trade. The Single- Market reforms in the early 1990s did away with many non-tariff intra-regional barriers, which also improved market access for non-European firms.

In 2006 the EU launched a new trade strategy centred on bilateral trade negotiations with emerging markets in Asia. This grand strategy has not been particularly successful.[2] Key elements of it were ill-advised, and the lack of progress was predictable from the start. *Global Europe* has not had any visible effect on the Doha Round. Other countries do not appear to have changed their positions because Europe launched bilateral negotiations with a selected number of countries. It seems more correct to say that the new bilateral strategy entrenched positions within Europe; some EU member-states seeking to protect their agricultural sectors portrayed the new FTAs as an alternative to the Doha Round. Bilateral agreements with an emerging Asia, some argued, would gain new market access without having to concede EU reductions in agricultural tariffs and subsidies. But such talk was on the fringe. Europe's Doha Round positions, like those of other countries, were largely unmoved by this bilateral strategy.

More visible, however, has been the failure to achieve results on the bilateral front, with the exception of South Korea. The new agenda attempted to revitalize Europe's negotiations with the Latin American Mercosur group and the Gulf Cooperation Council (GCC). These negotiations were literally and figuratively a legacy from the last century. They had been on the books for a decade or more, and obstacles to finishing them were well known. To no one's surprise, these negotiations have not made real progress since 2006.

Global Europe also singled out ASEAN (the Association of Southeast Asian Nations), India and South Korea for new preferential trade agreements. This was new for EU trade policy: emerging Asia was to become front and centre in Europe's new bilateral drive. A new trade deal with South Korea was considered a necessity as the United States was finishing its negotiations with South Korea for an FTA. A region-to-region negotiation with ASEAN was considered a way for Europe to help Southeast Asia form its own common market. It also justified a new trade deal with countries that had been knocking individually on the EU's door for some time, but that as individual countries were not significant enough from a commercial viewpoint. Lastly, a deal with India, with its large and rapidly growing market, was seen as a way to integrate more closely with a developing country whose export strategy rested more on services than manufacturing.

Negotiations started in 2007, but only those with South Korea have made any progress. The EU and South Korea have agreed terms for an FTA, but ratification in the EU depends on overcoming opposition from German car producers. The negotiations with India stalled soon after they were launched. Substantive negotiations with ASEAN have not started at all. Current efforts are directed at finding a subset of ASEAN countries willing and capable of negotiating a trade agreement with the EU. This may take the form of FTA negotiations with individual ASEAN countries – which would be commercially much less advantageous than a serious FTA with ASEAN collectively.

The new trade strategy also involves negotiations with China and Russia. These are not negotiations about classic FTAs; nor are they presented as such in Global Europe. Rather they take the form of Partnership and Cooperation Agreements (PCAs). Current trade-cooperation agreements with China and Russia are weak and do not cover many of the commercial aspects included in stronger bilateral trade agreements. But as FTAs with these big markets have been ruled out (because Russia is not yet a member of the WTO; and China is too competitive and its policies considered too opaque for an FTA), the PCAs are considered an alternative way of dealing with bilateral trade tensions and negotiating better market access. Hence EU trade-policy ambitions in these PCA negotiations are substantial.

With China, Europe has also set up a High Level Economic and Trade Dialogue Mechanism (hereafter the High Level Dialogue), intended to be a forum for discussions and negotiations about commercial policy.[3] This is modeled on the US-China Strategic Economic Dialogue, the framework used by Hank Paulson, the former US Treasury secretary, to get better market access in China while at the same time containing US protectionist initiatives directed at China.

PCA negotiations with China are intended to upgrade a commercial agreement dating back to 1985. They have been launched but have not really started. Nor do they seem likely to start in the near future. Political sensitivities are high, and have intensified lately. The High Level Dialogue was launched at an EU-China summit in Beijing in April 2008, but in contrast to the Sino-US dialogue, the High Level Dialogue has hardly produced anything at all.

PCA negotiations with Russia were launched in the summer of 2008. But less than a month after the launch, Russia invaded Georgia. Europe's response was to put these negotiations in the freezer. They were relaunched again in November the same year, but expectations for these talks are not high. The trade component in these talks got much more complicated after Prime Minister Putin announced the withdrawal of Russia's application to join the WTO in favour of a customs union with Belarus and Kazakhstan (though President Medvedev has sent contradictory signals that Russia's solo WTO application still stands). Russian membership in the WTO has been a prerequisite for the EU to move towards a Free Trade Agreement with Russia. Hence, the uncertainty hovering over Russia's WTO application will prevent substantial trade negotiations between the two parties.

What has actually been achieved in the past decade? The EU has had one major – though indirect – trade-policy success: the transformation of a patchwork of first bilateral trade agreements, and then Europe Agreements, into the full accession of twelve new members into the EU in 2004 and 2007. This is a historic achievement: it enlarges the EU's internal market; and it incorporates the new member-states into the Common Commercial Policy. That said, the trade-policy aspects of the accession negotiations (concerning trade with non-EU countries) were a minor component of overall negotiations. And so far the new members have made little difference to overall EU trade policy.

That aside, several Stabilisation and Association Agreements with neighbours have been agreed (such as those with Albania, Croatia, Macedonia, Montenegro and Bosnia-Herzegovina). Economic Partnership Agreements with ACP countries have been signed (as interim or final agreements) to allow for continued preferential openness to the EU market after the WTO waiver for Europe's preexisting Lome and Cotonou agreements with ACP countries expired. Of greater commercial relevance have been the FTAs with Chile, Mexico and South Africa. But these agreements were signed very early in the new millennium and were a vestige of the trade agenda of the 1990s.

EU trade policy: emerging protectionist threats

Despite this thin record of trade liberalisation in the new millennium, Europe's trade has increased considerably. Exports as well imports, intra- as well as extra-EU trade, have grown at very high rates. European multinational firms have continued to drive much of this trade – and associated flows of foreign direct investment – as they have extended their supply chains to benefit from lower production costs in other countries. European consumers have benefited from falling costs for many consumer goods and greater product variety. Technological developments and falling transaction costs have been the chief determinants of this trade and FDI growth, whilst previous rounds of policy liberalisation have also contributed.

However, the absence of new liberalisation will slow future growth in trade and FDI. Nor should all past liberalisation be considered safe from reversals, as trends in EU trade and regulatory policy rather suggest increasing protectionism. What are the main emerging protectionist threats?

Stalled economic liberalisation

Economic crises in the 1980s and the early 1990s triggered market-based reforms around the world. This involved macroeconomic stabilisation, often followed by other macroeconomic reforms such as central bank independence and inflation targeting, combined with microeconomic liberalisation, such as market deregulation and privatisation of state-owned companies, to stimulate greater competition. This trend has clearly slowed down in the new millennium. Reforms have not been repealed, but the few efforts to advance further economic liberalisation have not been successful.

This slowdown has affected EU trade policy. The latter is often a reflection of domestic economic policy; and lately there has been little impetus for external reforms from domestic reforms. In contrast, in the early 1990s, the Uruguay Round of trade negotiations enjoyed the tailwind of Single-Market reforms in the EU and an overall policy climate of deregulation and greater competition. The overall policy climate in the new millennium has been less clement to market forces. It has stymied initiatives in the EU to liberalise trade and increase competition. The most prominent example is the failed attempt to create a single market for services. A second version was approved by EU member states and the European Parliament, but it is a damp squib. Many sectors are carved out, and EU member-states can continue to discriminate against suppliers from other member-states on the grounds of regulatory differences.

The non-tradability of many services in Europe is itself a problem. It raises the cost of services. Relative prices are biased to favour consumption of goods rather than services. It also has a discernable effect on trade negotiations. Europe is not as aggressive as it should be when it comes to liberalising services trade in third-country markets. Many service providers feel threatened by foreign competition, including service providers in other parts of the EU. There is widespread concern that free trade in services would damage jobs and welfare in Europe. The closer one gets to services provided by the welfare state, the greater the sensitivities and defensiveness – also directed at other EU member-states. Healthcare, potentially a prominent export sector for Europe, is closed to trade and operates in an autarkic milieu. Not even a patients' rights proposal from the European Commission – little more than a codification of rulings by the European Court of Justice – can get the approval of the member states as it comes too close to opening national healthcare sectors to intra-EU trade and intra-EU competition. Such defensiveness cramps the EU's ability in trade negotiations to open foreign markets for European services providers. The lack of overall market dynamism in the European services sector also prevents the EU from trading off its agricultural protectionism for access to other countries' service sectors.

Standards protectionism

The EU has been a standard-bearer for labour and environmental standards in trade agreements. It tried to make them an explicit part of the Doha Round, but developing countries resisted on the grounds that they would be an open invitation for backdoor protectionism. The EU's bilateral trade agreements typically have provisions on labour and environmental standards, but they take the form of commitments to general principles and adherence to relevant international conventions. They are relatively weak and difficult to enforce. Again, resistance from trading partners probably explains why such standards have not become stronger than they are.

This is about to change: the EU is at risk of engaging in "standards protectionism" on an unprecedented scale. It is the policy for reducing carbon emissions that pushes it in this direction.

The EU has set targets to lower its carbon emissions. These targets are more ambitious than they are elsewhere. To that end, the EU has set up an emissions trading scheme (ETS), which limits the amount of carbon which can be emitted and enables parties to trade in emissions allowances. There are several problems with this "cap-and-trade" approach to carbon reduction. For starters, a simple carbon tax would be more efficient, transparent and fair than the quota-based, administratively complex ETS. But the main problem is that deep cuts in carbon emissions will increase European production costs relative to production costs in other countries that do not undertake similar carbon-reduction efforts. European-based companies might actually relocate to the latter, and replace production in Europe with exports to Europe from new host countries. This is known as "carbon leakage".

There is little evidence that current carbon-reduction measures have lowered the competitiveness of EU firms or provoked companies to move out of Europe. But as emissions limits are progressively lowered, the pressures will rise. Furthermore, the EU's two main trading partners, the United States and China, have not signed on to carbon reductions in a global agreement. The United States appears likely to take part in a post-Kyoto agreement; and a climate-change bill laying the ground for a US equivalent of the EU ETS is likely to be agreed by the US Congress in late 2009 or 2010. China might also be coaxed into signing an international agreement on carbon emissions. The problem for the EU is twofold. First, the United States is unlikely to agree to such big reductions as the EU plans to undertake. And second, China is unlikely to reduce its emissions at all. If it does sign an international agreement, it is unlikely to agree to anything more than limits to a projected increase in carbon emissions. Hence, it is not surprising that trade sanctions have entered the EU climate change debate – as a means of plugging potential carbon leakage, mitigating the damage to the competitiveness of European firms and encouraging other countries to reduce their carbon emissions. Specifically, this would entail the threat or imposition of tariffs on imports from countries that have not committed themselves to carbon reduction. Proposals have already appeared, but they have been postponed to the next round of negotiations for an international agreement on carbon reduction.

Carbon tariffs would be a serious blow to European trade, producers and consumers. They would also poison the trading system: a new set of trade restrictions would invite protectionist retaliation by other countries and on other grounds; it would probably unleash unprecedented legal conflict in the WTO; and put an already enfeebled WTO under much greater strain. However, carbon tariffs might be an appealing option for many protectionist-leaning EU member-states and intra-EU special interests who feel threatened, especially by competition from China.

Protectionism against China

There is a strong backlash in Europe against China's phenomenal rise in world trade. EU-China trade has exploded in the last decade, and China today ranks as Europe's second largest trading partner. Total trade between the EU and China has almost tripled in the last five years. Europe's bilateral trade deficit with China has ballooned, amounting to nearly EUR 200 billion in 2007.[4]

Yet, Europe has benefited much from trade with China; and the notion that a bilateral deficit represents a problem which must be corrected is simply bad economics. In contrast to the United States, the EU's overall current account is in balance and has remained stable (plus or minus 1 per cent of GDP) for the last decade. If a bilateral deficit really constituted a problem, Bulgaria, France, Romania, the UK and several other trade-deficit countries in the EU, should rather be worried about their deficits with other European countries – which dwarf their trade deficits with China.

But there is more to this story than meets the eye. The EU's trade deficit with China largely mirrors the replacement of other countries' exports to the EU. In other words, China's increasing exports to the EU have been accompanied by falling exports to the EU from other emerging markets. For example, in machinery and transport equipment, which features prominently in EU-China trade, China's surplus with the EU has increased by EUR 50 billion since 2000. But the EU's import of goods in the same category from other emerging markets has *decreased* by nearly as much in the same period. Similar patterns exist in other traded goods sectors, with China replacing other trading partners.

In the last decade, China has established itself as the final-assembly hub for Asia's trade with Europe. Supply chains in multinational firms have been "fragmented" to take advantage of labour-cost and skills advantages in various countries. China is abundant in cheap labour, and its comparative advantage lies in labour-intensive exports, particularly in manufacturing. Hence multinational firms have located labour-intensive production in China, mainly assembly operations for final goods exports to Europe and the United States, while locating other, medium and high-value added parts of their supply chains in other east-Asian countries. The latter export parts and components to China for assembly and re-export. As a result, a large part of China's exports is based on imports. "Processing" or "fragmentation" trade – the refinement of an imported good before it is re-exported – has been central to China's export-development model, and is estimated to account for between one-half and two-thirds of China's total exports.

The fragmentation of EU trade policy

The EU faces the fragmentation of its trade-policymaking process. This is happening more in the EU than in other jurisdictions. In the EU, as elsewhere in the OECD, the core ambition of post-war trade policy – to eliminate tariffs and other border barriers – has largely been achieved. But the next frontier in trade policy – the reduction of non-border barriers embedded in domestic regulation – trespasses on other policy areas, such as the regulation of services sectors, health and safety standards, food safety standards, intellectual property protection and government procurement. These are inherently "domestic". Hence trade policy's ever-expanding range enmeshes it in lots of domestic policy thickets. Yet there is an additional aspect of this development in the EU, given its peculiar hybrid of supranationalism and intergovernmentalism. Trade policy is one of the EU's few "hard" policy areas in that policy making is centralised in Brussels. From the Brussels vantage point, trade policy is also foreign policy and development policy. This makes it a tempting tool of action for other EU policy areas that might not be directly "trade-related", but in which direct EU competence is weak.

Another source of fragmentation is the limits to EU supranational jurisdictional competence in new areas of trade policy. The EU's competence has been extended to cover some aspects of services and intellectual property rights. But these new competences are limited, and they do not mandate the Commission to negotiate ambitious new trade agreements in these areas. Furthermore, there is no unified EU-wide regulation in both policy areas: the EU does not have a Single Market for services or a Community-wide patent system. This is a clear constraint on the EU's negotiating power vis-à-vis third countries.

Investment policy is another area with limited EU jurisdiction (apart from "post-establishment" matters, which are subject to Single-Market rules). The Commission has secured a mandate to negotiate some investment issues related to the General Agreement on Trade in Services (GATS) in the WTO. But this is a narrow mandate; it does not cover many investment issues that are front and centre in today's world of global economic policy. In fact, in these areas EU member-states compete with each other to secure advantageous access to third countries. The energy sector is similarly problematic: the absence of a Single Market for energy cramps the EU's ability to negotiate commercial agreements with third countries.

Such policy fragmentation constrains the EU's current agenda for trade negotiations. The lack of a unified policy for services and investment has decreased the chances of negotiating a substantial trade agreement with India, whose core ambition is to get better access for Indian investors and service suppliers to the EU. Investment and services are the core concerns European multinational firms have regarding access to the Chinese market. Core problems in EU-Russia relations – investment protection and the energy sector – cannot be adequately dealt with by the EU as it has no mandate for protection of European investments abroad and no common energy policy.

Conventional wisdom holds that these deficiencies will be overcome as soon as the Lisbon Treaty is adopted. That is not true. There is a possibility that Brussels will be given some extra competence in investment policy. However, it should be prepared for a situation where individual member-states will fight to retain competence on investment policy. Ultimately, this will have to be settled by the European Court of Justice (assuming no changes to the current treaty text). Even if the ECJ rules in favour of an expansion of jurisdictional competence, it will cover only a small part of relevant investment issues.

Creeping protectionism and tough times ahead

EU trade policy is sailing into turbulent waters. Its trade-policy strategy in the recent past has been unsuccessful. Prevailing political winds will make it even more difficult in the near-to-medium term future to conclude substantial trade deals. It is difficult to see what factors can lead to a quick and successful conclusion of the Doha Round. The EU's bilateral trade strategy will also likely remain stuck for a while. An FTA with South Korea might be signed in 2009-10, but that is the only one of the many bilateral EU trade negotiations that is within reach of a deal.

The agenda for autonomous reforms, already weak in recent years, appears completely stalled in the wake of economic recession. Rather, EU member states have responded to recession with Keynesian-style demand expansion, no supply-side reforms and extra microeconomic intervention – not least through bank bailouts and industrial subsidies. This is likely to strengthen protectionist thinking and spill over into protectionist measures. A 1930-style scenario of depression accompanied by spiraling protectionism appears unlikely; but Europe and other part of the world are facing a replay of 1970s-style recession, accompanied by greater *ad hoc* government intervention and creeping protectionism.[5]

Finally, the fragmentation of EU trade policy, particularly on non-border regulatory issues, weakens the EU's ability both to contain emerging protectionist forces at home and negotiate market access abroad.

Chapter 9

The reform of global economic and financial governance

Jean Pisani-Ferry and Nicolas Véron

From 2001 to 2008, the Bush administration had generally taken an openly scornful view of formal mechanisms of international economic and financial governance. It saw no reason to reform a system that seemed to work and indeed, until 2007 global economic conditions remained continuously favourable. This specific set of circumstances allowed Europeans to see themselves in the position of leading custodians of global economic co-operation, a position the US had long held since the Second World War, but without having to face hard choices for it.

2008 changed all that. The financial crisis evolved into full-blown global economic paralysis. Not coincidentally, Barack Obama was elected US president in November with a strong mandate for change, including on external economic policy.

In this new set of circumstances, the G20 summits of 15 November 2008 and 2 April 2009 can be seen as marking a turning point in the discussion about global financial and economic governance. The emphasis on the G20 format at the level of heads of state and government was largely the outcome of happenstance, as George Bush saw an opportunity to burnish his legacy at minimal cost following the Lehman episode, Nicolas Sarkozy eagerly wanted a high-level gathering before the end of France's

EU presidency during the second half of 2008 and Gordon Brown saw the opportunity of raising his international profile as the UK was set to chair the G20. The London summit of April 2009 allowed for a bit more preparation but was also marked by an incoming Obama team which had little time to focus on its agenda until the very last few weeks before the gathering.

Even so, the sense of a watershed has been unmistakeable. Before late 2008, the US was reluctant on global initiatives, the EU was by default the main cheerleader of multilateral action, and global financial governance was the premise of "the west". Now, in the words of Obama's victory speech, "a new dawn of American leadership is at hand"; the BRIC countries' participation is seen as a necessary condition for any legitimate collective action; Europe's internal divisions are more apparent; and the world has been confronted with the most all-encompassing economic downturn in living memory. This is quite a change of context.

In this chapter we discuss how the EU may adapt to this new context. We limit ourselves to the agenda for financial and macroeconomic policy, as other issues such as trade and energy/environment are the matter of other contributions in this pamphlet. We present the issues under discussion in three main categories: global standards (especially on prudential supervision and on accounting), global supervision, and global public institutions. This covers a wide range of topics and challenges. We focus here on those which we see as most potentially contentious, and on which we see the clearest need for the EU to take or change stance.

Global financial standards

Among the many sets of global financial standards defined in the past two decades[1], two stand out for their importance in the light of the financial crisis: the prudential oversight of banks, for which the main operational body at international level is the Basel Committee on Banking Supervision (BCBS), formed in 1974 and hosted by the Bank for International Settlements in Basel; and accounting, for which the key international standard-setter is the International Accountings Standards Board (IASB), which took over at its creation in 2001, the legacy of an earlier committee created in 1973. Both sets of issues are also addressed within the framework of the Financial Stability Board (FSB), created in 1999 (at the time as Financial Stability Forum, FSF) by the G7 in response to the Asian crisis and consisting of central banks, regulators and ministries of finance, in which international institutions such as the International Monetary Fund (IMF) and the Bank for International Settlements (BIS) also participate as well as the IASB. Until it's rebranding as FSB in early 2009, the FSF's main impact has been in building consensus on priorities rather than in drafting detailed regulatory requirements[2].

During most of the 2000s, the EU has been an active promoter of both the Basel 2 framework for banking supervision, finalised by the BCBS in 2004, and of International Financial Reporting Standards (IFRS), the accounting standards issued by the IASB and its predecessor body. In both cases, however, developments including those resulting from the crisis are forcing the EU to rethink parts of its position and define a clearer sense of direction. Beyond these common threads, however, the two issues involve different dynamics and each must be considered separately.

In a nutshell, Basel 2's main problem is that the content of the framework, which resulted from six years of painstaking negotiations, has been, in not insignificant terms, part invalidated by the lessons from the crisis. Basel 2 was intended to replace a simpler framework for risk assessment established in the 1980s to standardise the assessment of risk and define capital adequacy ratio, but key choices now appear questionable. To begin with, even before the crisis it was suspected of incentivising pro-cyclical behaviour. For the most sophisticated supervised institutions, it is heavily reliant on internal financial models that were meant to better represent actual risk than crude ratios. But it has now been revealed that even some worldwide banking leaders had severely deficient risk management practices; moreover, widespread risk assessment tools used by banks, such as value-at-risk measures, are unsuited to extreme events. Furthermore, for many other banks, Basel 2 refers largely to external ratings provided by credit rating agencies but these have failed the marketplace by not providing a robust enough risk assessment of mortgage-based structured products. Most ironically perhaps, one of the changes brought by Basel 2 is an overall reduction in the risk weighting assigned to residential mortgages, which have been the very trigger of the crisis[3].

The Europeans have been active promoters of Basel 2. They endorsed it through the Capital Requirements Directive of 2006 and have fully implemented it since the beginning of 2008 (the US, by contrast, has been consistently less enthusiastic). But now a substantial revision of the framework is necessary. As much as correcting the identified flaws, one much-discussed aspect is the introduction into the revised framework of contra-cyclical "dynamic provisioning", a practice pioneered by the Bank of Spain since the 1980s, even though it raises a number of complex policy questions[4]. Additionally, the long-overdue expansion of the BCBS's membership in early 2009 means new internal dynamics within the Committee, which have not yet been really tested[5].

In accounting, there has been much heated discussion about some IFRS standards, especially the use of the so-called fair value principle – in spite of the fact that no clear empirical basis has been found for the claim that fair value played a significant role in the crisis[6]. The fact that banks which incur losses are forced to quickly sell assets to maintain their capital, leading to harmful pro-cyclical effects, has been identified as an amplifying factor in the crisis; but this pro-cyclicality is better tackled by amending regulatory capital ratio calculations than accounting standards, in order not to sharply reduce transparency in the marketplace. Rather than the content of the standards, the most pressing issue in the near future is likely to be the governance of the standard-setting process itself.

The IASB offers a unique combination of private-sector governance and de facto public policymaking authority, whose economic impact is arguably unequalled by any other private institution. The standard-setting board, whose permanent base and staff are in London, is appointed, financed and hosted by the US-registered International Accounting Standards Committee Foundation (IASCF), which itself is currently governed by 22 Trustees. When the IASCF and IASB were created in 2001, the Trustees were appointed by an ad hoc group chaired by former SEC Chairman Arthur Levitt; Paul Volcker was chosen as the first chairman of the IASCF Trustees, a position he kept until early 2006. Since then, the Trustees in place co-opt new ones whenever a position needs filling, which has given substance to criticism of the Trustees as a self-appointed group (a Trustee appointment advisory group was established in 2005, but as its name suggests it only has a consultative role).

This arrangement made some sense when the IASB had only limited influence, before the EU decision to adopt IFRS was made in the early 2000s, but was rendered unsustainable by the worldwide impact of IFRS, which creates corresponding responsibility for the standard-setter. The IASCF's response to this challenge has been a "monitoring group" of public authorities, which was created in January 2009 and given a leading role in Trustee appointments. But this hastily drafted change, which at the time of writing had not yet been fully endorsed by the EU, is likely to create more problems than it solves[7]. Thus, the debate on how to reform the IASCF governance so as to allow adoption of IFRS in the US, and sustainability of their use in other jurisdictions including the EU, remains high on the agenda.

At this point, the answer to this debate belongs mainly to the IASCF and its Trustees. What is needed from European policymakers is not short-term action, but rather a clearly articulated vision of what principles should drive governance reform. Based on decades of accumulated experience, the EU should encourage the Trustees to reinforce what has been the key driver of the international accounting standard-setting's past successes, namely its primary orientation towards the needs of users of financial information, with investors on the world's capital markets prominent among them. While this may sound self-evident, it is not: recent discussions have largely focused on whether the IASB should be given a specific financial stability mandate, which in some interpretations may conflict with the information needs of users of financial reporting. As the clear orientation of accounting standards towards users' needs is likely to remain an essential concern of US policymakers, its endorsement by the EU would also be a condition for a transatlantic alignment of views about the future of IFRS governance, which appears somewhat in doubt at the time of writing.

Global financial supervision

The next set of critical and difficult questions relates to the international reach and consistency of supervision of financial market participants, as a consequence of financial globalisation. Common standards and principles are of little use if they are implemented in widely different ways, or in some jurisdictions not implemented at all. Indeed, the territorial loopholes and inconsistencies of public oversight have played an important role in the crisis: for example, the fact that the off-balance-sheet commercial paper conduits established by some German banks were located in Dublin rather than in Germany partly explains why they were neglected by supervisors, a key factor in the sorry stories of IKB, Sachsen LB, WestLB and Hypo Real Estate among others.

Possibly the most pressing question is about how to supervise large and complex cross-border financial institutions. On this issue, the European mantra, endorsed by the November 2008 G20 declaration, has long been the creation of supervisory "colleges", which are meant to bring together national supervisory authorities with jurisdiction over a specific international financial firm under the coordinating authority of (generally) the home-country supervisor. The EU has also given formal status to such colleges in the revisions of its own capital requirements directive (for banks) and the so-called Solvency 2 directive (for insurance companies).
Unfortunately, such colleges are unlikely to make any significant difference. Either they give binding authority to the coordinating supervisor or to

the entire college by majority vote, which amounts to the transnational or supranational delegation of sovereignty they are designed to eschew; or they remain mere talking shops, which could be useful in allowing exchanges of information and best practices (they already exist to large extent) but will not be up to the challenge of effectively supervising cross-border actors. A taste of this dilemma was given by the discussion in late 2008 of the Solvency 2 directive, in which a proposal to give centralising authority to the home-country supervisor was eventually ditched, to the disappointment of the European Commission and of several member states.

In fact, there can be no institutional response to this challenge at global level, because as emphatically indicated in the November 2008 G20 declaration, banking supervision remains a national prerogative. However, Europeans can significantly improve the situation by using the EU's existing framework for supranational policy and create an effective EU-level supervisor with prudential authority over Europe's largest and most complex financial-services firms. This has arguably become a necessary condition to safeguard the economic benefits of financial integration in the EU in an era of financial reregulation. It remains to be seen whether the European Banking Authority whose creation was decided by the European Council meeting of 18-19 June 2009 can eventually play such a role.

Beyond financial institutions, the crisis reinforces the challenges of regulating other international market participants. Rating agencies provide an example of the difficulty: until 2009 these were regulated only in the US – since 1975, by the SEC under a light-touch regime – but their failings especially in rating structured products have created considerable political demand for their regulation elsewhere as well, and the EU has introduced draft legislation to such effect. The controversy about EU regulation of rating agencies in 2008-09 illustrates how difficult it can be to regulate global actors in a credible way, without erecting protectionist barriers or extending regulatory powers on a politically unsustainable extraterritorial basis. The same difficulties may arise in the area of regulation of hedge funds, which is now envisaged on both sides of the Atlantic. There is a high risk that regulatory initiatives which do not form part of a global or at least transatlantic agreement contribute to a trend towards fragmentation of the global financial space, which would be economically harmful for all players.

A related issue, which was a key focus of the London meeting of the G20 in April, is about how to bring tax and regulatory havens into international regulatory frameworks. Here, the key challenge for the EU remains to bring its own house in order. Many of the world's most active tax and regulatory havens are either EU member states, or dependencies of member states (especially of the UK and the Netherlands), or small sovereign nations with strong political links with member states (such as Andorra or Monaco). While a number of such havens are generally not considered uncooperative, a continued focus on the issue may create hard choices for the EU or at least some of its member countries.

Global public financial institutions

In the discussions about institutional architecture, the two sides of the Atlantic coincide in many respects: the US and the EU still *de facto* control the key existing international financial institutions created by the Bretton Woods conference of 1944, the International Monetary Fund (IMF) and World Bank, and even more the G7, a later addition which increasingly assumed the role of a caucus within the system. They are the incumbents, and this results in them having common interests. However, on the basis of recent developments and of a reasonable expectation of what the position of the US may be in the near future, they diverge on three accounts.

First, the US remains distinctively less keen on giving the IMF the central role in the reformed global governance that was advocated by the European heads of state and government in their declaration of 7 November 2008. True, the Obama administration markedly changed tone in comparison to the previous one. It promoted the increase in IMF resources and the general allocation of Special Drawing Rights that were decided upon in London in April; and Treasury secretary Tim Geithner endorsed that IMF surveillance applies to all members – including the US – in his statement to the International Monetary and Financial Committee in April 2009. But while, according to the Europeans, the IMF "enjoys the legitimacy and universality necessary to become increasingly the pivot of a renewed international system", the US political system traditionally sees it as an important agency for, *inter alia,* providing conditional assistance to countries in crisis and exercising surveillance over exchange rate policies, but not as a supranational body able to override national governments, nor even an embryo thereof. A permanent majority of Democrats and Republicans in Congress is suspicious of the IMF and every administration has to spend political capital to pass legislation that gives it additional means, let alone widens its mandate[8]. This is why increasing the IMF's resources is always difficult for the US administration, whatever the necessity of such a decision, as was illustrated again in 2009 when the Obama administration had to link it to a military appropriation bill to force congressional approval of the commitments made at the G20 London summit.

Second, Europe and the US have differing views on the reform of IMF governance and specifically on the issue of voting rights and quota. The Europeans are notoriously overrepresented in the IMF[9] and nominally at least, they have much to lose in any ambitious reform of its governance[10], while the US does not feel threatened by potential reforms as long as they do not imply that they are deprived of their veto power resulting from the fact that its 17% weight makes it impossible to reach the 85% threshold for major decisions without its consent. According to Tim Geithner[11], "much bolder action is required to realign quotas toward dynamic emerging market economies, and the next general quota review is an opportunity that must be seized. Minor adjustments around the edges are inadequate to an IMF for the 21st century". This implies a faster reduction of European weight in favour of developing countries. The US even had the luxury of accepting to forgo the increase in its weight that would have resulted from the mechanical application of the IMF's indicative formula, whereas European countries had to fight to avoid too sharp a reduction of their own voting power.

Third, the US government has in recent years been keen on using the IMF as a conduit for its criticism of China's exchange rate policy and to put pressure on the Chinese government to change course on this issue. In 2007, it was instrumental in the revision of the 1977 IMF decision on exchange rate surveillance in order to make room for an IMF pronouncement on the inadequacy of the dollar peg of the renminbi[12]. This is in large part an effect of internal politics and specifically of the introduction in Congress of no less than three simultaneous bills mandating some form of trade retaliation in response to a lack of Chinese flexibility on exchange rate matters[13]. By the middle of the decade, the Chinese exchange rate had reached the top of the US foreign economic policy agenda and the only matter for discussion was whether it was preferable to push for change through the multilateral or the bilateral route. The concern about the issue is unlikely to abate as Congressional democrats have been active promoting some form of response to the perceived undervaluation of the Chinese currency.

For long, Europeans have been much less concerned by China's external surplus – they even looked indifferent to the exchange rate issue until at the end of 2007 they finally sent a high-level mission to Beijing for discussions. However, the conspicuous US external deficit hides the fact that there is no strong motive for this difference in attitude between the two sides of the Atlantic. On the contrary, there could have been reasons for the Europeans to start expressing their concern earlier[14]. So the difference here is probably a matter of intensity and approach to international economic relations rather than of substance. The Europeans share concerns with exchange rate misalignments and support a stronger role for the IMF in addressing them, but they are less obsessed with China and more willing to balance the costs and benefits of using the IMF to censure Beijing's policy.

Face off: a realistic role for Europe

The Obama administration has started distancing itself from the frequently unilateral approach of the Bush administration, and leaning towards multilateralism. However, it does not follow from this that differences with Europe will be easily reconciled. From congressional politics to geopolitical realities and diplomatic traditions, there are deep seated reasons for these differences and it is fair to assume that they will not disappear any time soon. Thus, the EU should prepare for difficult compromises.

On global governance, the idea that the IMF could recoup the central role it was assigned by the Bretton Woods system is an illusion. Michel Camdessus' dream of transforming the International Monetary and Financial Committee (IMFC) into the overarching governing structure for the world economy is beyond reach.[15] There is no support for it among the main emerging countries, nor in the US. To characterise the informal and evolving character of world economic governance, World Bank President Robert Zoellick[16] spoke of a new "*Facebook* for multilateral economic diplomacy" and this telling image indicates how much the world has changed since the days of Bretton Woods. For all its shortcomings, the G20 has emerged as a key grouping which conveys political legitimacy and the IMF cannot dream of substituting it. A realistic role might be for it to "make friends on Facebook", i.e. to adapt to a distinctively less structured system than it was initially built for and provide input to the G20 and other groupings which are deprived from a permanent secretariat that provides an analytical framework and ensures rigour and consistency. Such a strategy would represent a realistic version of what the Europeans were aiming for in the discussions preceding the G20 summit in November 2008.

On representation, the Europeans need to stop trying to buy time and postpone the inevitable. The risk for the IMF and other multilateral institutions is now to see their effectiveness significantly impaired for lack of legitimacy in part of the emerging and developing world. Marginal concessions will not satisfy China, India or Brazil. On the contrary, they may convince them that it is in their best interests to wait until they are strong enough to overthrow the existing institutions and replace them by new ones where they are adequately represented. The US is visibly aware of this reality and this is why it supports a more significant re-weighting of votes – as long, at least, as it keeps its veto power. Indeed, the US has called for a reduction in Board chairs from 24 presently to 22 in 2010 and 20 in 2012, at the expense of the Europeans, but insists on keeping its own voting share constant. This is unlikely to satisfy the emerging countries because they know that the combination of US veto power and Washington location ensures that when it comes to policy choices, the influence of the US is much more pronounced than that of Europe. The Europeans would be ill-advised to continue procrastinating and they should instead prepare for a significant offer through which they would trade-off a substantial reduction of their combined quota and at least a partial consolidation of their seats for specified reforms of the IMF's mandate and the abandonment by the US of its veto power.

Finally, exchange rate surveillance is a field where Europe, which has avoided controversial positions so far, can try to play the role of an honest broker between the US and China. The reform of the 1977 decision on exchange rates was misguided and it has not delivered any significant result. Europe should support the US view that exchange rates are a matter for surveillance but oppose the uneven implementation of surveillance and the absence of any significant recommendation to the US in recent years.

Chapter 10

A single European seat in international financial institutions

Pier-Carlo Padoan

The new global context emerging as a result of the financial crisis makes the case for a single EU (or euro area) seat in International Financial Institutions (IFIs) stronger and more urgent. The crisis itself is the result of both policy and market failure. The international macroeconomic aspect of this twin failure is reflected in the inability to address global payment imbalances that have accumulated over a decade or so, and in the belief that markets could finance such widening imbalances thanks to their resilience and efficiency. The post-crisis reconstruction requires, among other things, a serious reconsideration of how to deal with global macroeconomic imbalances, now and in the future, through cooperation among all major players, including the large emerging economies. This, in turn, requires a new mandate for the International Financial Institutions and for the IMF in particular. For example, a new IMF should be given political leverage to pressure all major players into taking collective responsibility on policy adjustment. Such a new mandate requires a strong and effective European voice both in the IFIs and in the evolving constellation of the Gs (G7, G8plus and G20).

Rapid and deep changes in global governance

Global governance structures change under the pressure of events (especially during a crisis), under the pressure of countries (when the distribution of power among major players is significantly modified) or because the efficiency and credibility of existing institutions fall below some "critical" threshold. In other words, when the supply of governance falls below demand.[1]

The times we live in contain all three elements. First, the crisis has exposed inefficiencies in the way that financial markets operate and the inadequacy of policy. Second, there is no doubt that the number of relevant players in the global economic scene has increased. And there can be no doubt that the large emerging economies (the BRICs) must be part of the solution to the challenge of creating a new sustainable economic order. Finally, the crisis has revealed that, though they are not the only ones to be held responsible, IFIs, and the IMF in particular, were unable to prevent the crisis from happening. All these elements interact. The crisis has generated major responses from governments, but beyond the short-term response, it calls also for a reform of IFIs (particularly the IMF), so as to make them more effective and responsive.

The collapse of Bretton Woods II

The financial crisis escalated and eventually erupted over the macroeconomic framework that has developed over the past two decades, usually referred to as "Bretton Woods II".[2] Prior to the crisis, the main engine of growth in the international system was US domestic demand, especially household demand, itself driven by increasing employment in a low inflationary environment. This was made possible by an exceptionally long period of sustained productivity growth, generated by the mechanism often referred to as the "new economy", following the introduction and diffusion of information and communication technologies. An increasingly unregulated financial system acted as a very powerful multiplier and facilitator of this mechanism, allowing households to consume in excess of income and leverage on the (expected) value of their property. With hindsight we can say that the financial crisis that initiated in the mortgage market is the result of an endogenous mechanism (thoroughly analysed by authors such as Hyman Minsky[3]) which has gone through the "classic" phases of "manias, euphoria, and panic". The history of financial crises is full of such events, all apparently different from one another yet, apart from the specific episodes that have generated them, all reflecting a similar mechanism. Therefore, Bretton Woods II provided the specific, global macroeconomic environment that led to euphoria first and to crash afterwards.

Such a macro environment has generated an increasing US current account deficit matched by a surplus in emerging economies, particularly in China, whose exports have fed US consumption and emerging market growth. In China this was facilitated by a fixed exchange rate between the dollar and the yuan (de facto a dollar peg) that protected competitiveness and boosted reserve accumulation. The latter was largely reinvested in the US financial market (up to a fifth of China's reserves were invested in Fannie Mae and Freddie Mac). One relevant consequence has been that the US financial system has enjoyed abundant liquidity, fuelled by US monetary policy. This has occurred in the context of rapid financial innovation, which was well beyond the mortgage market, and combined with weak regulation and oversight. This, in turn, has facilitated the growth of the housing market bubble and the subsequent bust. Other advanced economies, such as Europe and Japan, played "secondary" supporting roles. Both economies suffered and continue to suffer from structural low growth, both need structural reforms to boost long term growth, and both are in the back seat as engines of global growth.

The current crisis has destroyed the fundamentals of the Bretton Woods II model. Such a model was based on the idea that excess surplus in emerging economies (including oil producing countries) would be reinvested in the centre of the system as the US economy, which was considered the "safe haven" par excellence. The crisis has destroyed the credibility of the centre and with it, the main engine of growth and of financing of growth. It is highly unlikely, if not outright unthinkable, to expect that in the foreseeable future the main engine of global growth will be US household demand, fueled by sophisticated and opaque financial instruments.

A new multi-polar growth mechanism?

Growth will resume after the recession but it is possible that, structurally, it will be at lower levels. More importantly, global growth will be driven by several engines rather than by a single one. Yet each of the engines will be less powerful than the one that has collapsed, and partly disconnected from the others. Household demand in the US will be (partly) replaced by exports, driven by a weaker dollar and by the still powerful US productivity engine. It remains to be seen if US investment and innovation will be able to generate, at least in part, a productivity cycle as long and intense as the one that was behind the "new economy" of the 90s. It cannot be ruled out that, as global value and innovation chains restructure, part of the innovative and productivity potential will relocate away from the US towards the BRICS, especially Asia, adding to the growth potential of these emerging economies. US economic power will further decline if only in relative terms.

It is much harder to believe that the BRICS will quickly take the driving seat as global engines of growth. Long term projections usually place China (much less so India) as the top economy twenty to thirty years from now. Most of these projections, however, extrapolate in the future a scenario which is not there anymore: a relatively stable world economy where global markets are open, economic integration progresses and no major crisis occurs. It remains to be seen whether or not the current crisis will allow us to carry on with these assumptions. Whatever the case, sooner or later emerging economies, large and small, will have to face the challenge of their internal transformation as domestic demand will have to be given more space and export-led growth will be less relevant. Such a transformation will need to be accompanied by, and possibly support, a sustained high rate of growth – a necessary condition for these countries to raise the standard of living of the large part of their populations still below the poverty line. Needless to say such a transformation will be politically, even more than economically, difficult and risky and its outcome remains uncertain at best.

What about Europe? The old problems are still there and the financial crisis has made them more acute. Europe in Bretton Woods II has been a slow growth economy. It could grow even less in the future as the crisis produces a permanent negative impact on potential growth.[4] The massive use of fiscal measures to deal with the financial emergency first and with the recession later will loosen fiscal discipline (and will make long term debt sustainability more difficult). More flexibility in the application of the Stability and Growth Pact is welcome, and needed, but there is a risk that the credibility capital accumulated over a decade could quickly vanish. What is even more of concern for the European economy is, on the one hand, the possible widespread and unregulated adoption of subsidy measures for (non financial) industries which will distort competition, and on the other hand, a weakening of the structural reform and liberalisation effort as political capital to implement reforms will be in short supply. This latter outcome could further undermine European growth.

A similar story can be told for Japan. After a decade of stagnation and near deflation structural problems are unsolved and growth prospects remain subdued.

So, what could be the global macroeconomic scenario in the post Bretton Woods II world? How will sustained and sustainable growth be possible? Financial crises can hardly be declared finished until sustained growth resumes, without which financial sustainability cannot be achieved.

Sustained growth in a multi-polar world requires an open multilateral trading system and a stable macroeconomic environment. If the first condition is not available, protectionism and mercantilism would prevail. If the second condition does not hold, global imbalances would again develop and, possibly, lead to a new crisis. To what extent will the new distribution of economic power allow for a cooperative scenario to support global growth? And to what extent does this new scenario require reformed IFIs?

The new power distribution and the reform of the IFI's

The rise of new players and the redistribution of economic power impacts first of all on the role and legitimacy of the informal bodies (the Gs). The G8 is taking steps toward enlargement. The Heilingendamm process, launched by the German G8 presidency in 2006, has established a structured interaction between the G8 and five major players (Brazil, China, India, Mexico and South Africa). At the same time, the Leaders summit in Washington, in November 2008, has adopted the G20 format. Furthermore, the G20 summit in Pittsburgh has declared the G20 the main forum for international economic cooperation.

This suggests that a dilemma is emerging. On the one hand, the extension and severity of the financial crisis has been such that all major players must be involved in global economic governance. On the other hand, a larger number of players will make it more difficult to reach common views. The dilemma is particularly relevant for the reform of international organisations. There are two aspects to be considered here. First of all international organisations require reform of their mandate and governance. Second, effective and sustainable governance of the global system requires a coherent and balanced division of labour among different international organisations. Insuring coherence and encouraging collaboration is primarily a task for those who sit on the governing boards of such organisations. So an effective reform of the IFI requires agreement among the major players and, by implication, a different role for the Gs to reflect the changing balance of international power.

Even in normal times the decision making process in IFIs is informally, but significantly, influenced by the Gs. In the IMF and World Bank, the decision making process is to a large extent the result of the interaction of management with the G7/G8 and groupings such as the G11, that bring together several emerging markets. Only in the recent past have the European members of the boards begun to coordinate their positions. Not surprisingly the G20 has called for a reform of the mandate and governance of the IMF where the emerging economies should have greater weight and voice and indicated that the Financial Stability Forum (now Financial Stability Board) will include major emerging economies.

But, in addition to a change in governance, how should the mandate of the IFIs and of the IMF in particular be modified after the crisis?

The financial crisis has put the spotlight on the IFIs who are, at least in part, held responsible for failing to prevent the crisis. Indeed, especially in the case of the IMF, there has been a major surveillance failure. During the first part of the current decade the key issue in international surveillance, at the IMF and elsewhere, was how to address global payment imbalances. The view of the IMF, and other international organisations, has been that global imbalances were not sustainable in the long run and needed appropriate action by all relevant players, including fiscal adjustment in the US to restore domestic savings, growth enhancing structural measures in Europe and Japan, exchange rate flexibility in China to support domestic demand, and enhanced internal absorption in oil exporting countries. The IMF also warned that, as the size of imbalances was growing, financial markets would find it difficult to continue to provide resources to finance such imbalances without increasing overall risk. In addition, as Jean Pisani Ferry[5] has argued, the credibility of the IMF in anticipating crises has recently improved. From this point of view therefore the IMF was, in part at least, able to fulfill its surveillance mandate. So it could be argued that, as an international organisation, the IMF has demonstrated that it suffers only from a limited efficacy gap. Where the IMF has failed is in the ability to obtain the implementation of its recommendations, pointing to a much more serious legitimacy gap.

The global imbalances episode has highlighted one well known feature of the way the IMF (and other IFIs) operate. The IMF can have significant leverage over countries that request its assistance. But the leverage of the IMF on large and advanced and, increasingly, on emerging economies is limited if outright nonexistent. The financial crisis was generated in the centre of the global economic system and, as mentioned, can be seen as the result of both policy failures (failure to implement the needed adjustment and supervision measures) and (financial) market failure. If future crises are to be avoided, both failures have to be addressed. This will require a better regulatory environment but also a better macroeconomic policy environment: a mechanism that will ensure that global imbalances such as the ones that fed the crisis will not arise again. In short, we will need a credible collective mechanism to deal with global macroeconomic policy. What could be the role of a reformed IMF in this new environment? One can imagine two scenarios. The first is a strengthened, but largely traditional, IMF whose mission would be to support countries in crisis, but possibly having larger resources. This is, per se, an important mission as the financial breakdown has sparked a new string of crises in countries, including some of the more advanced ones.

Another, more ambitious, scenario can also be envisaged. The crisis has prompted a global and coordinated response, that would have been hard to imagine only a few months back. This is a welcome outcome but the drive for sustained cooperation will eventually decrease and vanish as a new "normal" policy environment is established. Bretton Woods I (the "real" Bretton Woods) worked well for a limited period of time and eventually broke down when the interests of the major actors could no longer be reconciled and incentives for international collective action were no longer in place.[6]

A remodeled IMF should have the primary task of ensuring that such incentives do not fall below a critical threshold and see that when national interest cannot be reconciled, and may lead to a collapse of the system, appropriate actions are taken to preserve the international public good of macroeconomic and financial stability. In other words, if one, or several, major economies (a more likely situation) need to take action to correct global imbalances, there must be a mechanism, and an institution, with the leverage to make it happen

Can the IMF be such an institution and how should the IMF be reformed to fulfill such a role? First of all the IMF could have additional policy instruments. The new exchange rate surveillance remit is a step forward but it falls short of a mandate to look into countries manipulating exchange rates and does not have a mechanism to start binding action.[7] In the area of financial sector surveillance, one additional step forward is included in the G20 November 2008 communiqué which calls for compulsory FSAPs (Financial Sector Assessment Programs) for all its members (including the US, which has repeatedly refused to undergo the FSAP). More effective surveillance in the area would be needed, possibly in conjunction with the FSB as also mandated by the G20. Furthermore, the G20 have decided to substantially increase resources for the IMF. But in addition to better instruments and resources, a "high profile IMF" requires a much stronger peer pressure mechanism under the leadership of the major economies. This is why a single European (euro area) seat could represent a major advancement.

Early steps towards stronger surveillance

Some steps in this direction have already been taken in the recent past. In the context of its Medium Term Strategy review, and in order to address the issue of global imbalances, in 2005 the IMF introduced an informal consultative group, made up of the United States, Japan, the euro zone, Saudi Arabia and China, i.e. all the major players in the global imbalances scenario, including non G7 members (but not all G7 members belong to this group). In light of the crisis, the assessment of this group's impact is poor to say the least but the message conveyed is important. Effective multilateral surveillance must involve all relevant players, (not necessarily G7 member countries) and, especially, those players whose performance has systemic implications.

Why is it that this informal group was ineffective despite the fact that it included all relevant players? One reason is that members of the group lacked incentives to act according to the policy recommendations supported by the IMF (and the G7 in a number of communiqués). Japan, a surplus country, following a decade of stagnation, had dissipated the political capital for a credible reform effort. Saudi Arabia was in a similar position although for quite different political and institutional reasons. The euro area was (and remains) in a peculiar position. Its external balance was (and is) in equilibrium so, at first sight, the euro area had no responsibility for global imbalances. On the other hand, Europe was pressed to move ahead with structural reforms to boost growth, but any progress from this point of view could hardly be the result of external peer pressure if agreement among members of the EU was not available. The US and China, in turn, adopted policies clearly inconsistent with a multilateral adjustment package.

This state of affairs left global macroeconomic management in Bretton woods II within US-China bilateral relations, with Europe adopting an attitude of (possibly benign) neglect, as the consequences of dollar weakness and Chinese peg were bearing on the euro appreciation. This bilateral relationship, and its consequences, for some time have been passively accepted by Europe. The crisis makes such a scenario untenable, the more so in the light of the recession as a strong euro further depresses EU growth. More generally, as the crisis requires a new global macroeconomic framework, all major players have to also reconsider relationships between major currencies. This requires both flexibility and orderly burden sharing in adjustment. One could consider measures that would, for instance, link the Chinese yuan to a basket of currencies, or identify "target zones", or allow for the Chinese exchange rate to be fully flexible. More generally, what the Bretton Woods II experience shows is that a weak European voice can be interpreted as a lack of interest or, worse still, as passive acceptance of events.

The time is ripe

Both the IMF and the World Bank are governed by Boards with 24 members who have different shareholdings, representing 185 countries. The United States has the single largest share, with a little over 17%. Taken together the member states of the European Union have a larger share than the US. France, Germany and the United Kingdom represent a single country constituency each. The other European Union member states are distributed over six constituencies, and in several cases also hold the executive director positions. The IMF and World Bank Boards operate on a consensus basis. This means that what happens upstream, most often in the framework of the G7 for the advanced economies and the G11 for emerging economies (including China), and possibly in the G20 from now on is of essential importance in establishing consensus. Although they do not have an absolute majority, historically G7 countries have had a predominant position in the decision-making process. In recent years, European countries have also developed a coordination method, in Brussels and in Washington, on the basis of which some of their Board decisions are taken jointly. Interaction between the G7 and the European coordination group is complex, sometimes fraught, and at times European members of the G7 have upheld positions different from those of other EU governments.

A single EU, or at least euro zone, representation in international financial institutions would increase Europe's clout in global governance while at the same time improving global governance by enhancing the involvement and accountability of new emerging economies. A single EU (or euro zone) representation, if set on the same level as the US, would carry more clout than the current sum of EU representatives[8] while at the same time making space available for a larger share for emerging economies (as indicated by the G20 Washington Summit). But there is more to this. Europe is currently faced with a paradox. Computing Europe's weight as a "swing voter", one can conclude[9] that if Europe were to speak with a single voice, it would carry the vote in practically all cases. But, and therein lies the paradox, Europe has to date proved largely incapable of using its economic and political clout in global governance precisely because it has spoken with multiple voices.

Why hasn't Europe taken the decisive step towards single representation? Two possible explanations can be offered, that are partly complementary: different preferences and dysfunctional governance. Differences in national macroeconomic policy preferences would stand in the way of European countries arriving at joint positions in international fora, just as different trade policy preferences would weaken EU positions in WTO negotiations. This assumption is not very convincing if we think of how the euro implies a single monetary policy, regardless of the fact that a single monetary policy may at times yield differing outcomes in different euro zone member states. One could argue that having single representation within the IMF would imply speaking with a single voice also regarding fiscal issues, a field that has remained the purview of individual member states. But this is not a very convincing argument either. On the one hand, the Stability and Growth Pact requires fiscal policy convergence and shared policy criteria for all countries. On the other, through surveillance the IMF is already assessing the euro area's fiscal policy both in terms of internal consistency and operation, and in terms of global macroeconomic impact.

This leads us to the dysfunctional governance or decision-making inefficiency, assumption.[10] Regarding macroeconomic relations, this describes EU countries' difficulties in identifying an internal decision-making mechanism that would yield joint positions in international fora. Put differently, there is no point in setting up single representation within the IMF if the Executive Director for Europe is not given clear and timely guidance by his or her authorities (while Executive Directors for individual European countries do receive such guidance from their capitals).

Up until now there has been no such handing over of sovereignty and many European governments remain opposed to concrete steps that might lead to single representation. The reason this is not happening is simple. Moving to single representation would involve redistributing power within the European countries' group. The larger countries would need to relinquish part of the clout they currently wield including in Gs groups, whereas smaller countries (who are not G7 members and therefore are fearful of loosing even more visibility and voice) are even more fearful of losing clout to larger countries.

Pressure for changes was present even before the crisis broke out for at least four reasons. Firstly, shifts in economic power and the move to regional or bilateral governance models have already reduced the clout of individual European countries, none of which can aspire to global player status. Secondly, pressure also comes from the fact that single euro zone representation in financial institutions would free up space to increase shares for emerging economies, allowing for their increased involvement and consequently for more balanced international relations' governance, which would, in turn, facilitate the reform of IFIs. Such a goal should be in Europe's interest. Asian countries, including China, would carry more weight but also more responsibility, as shareholders. Thirdly, pressure stems from the euro's role. The single currency's weight as a key currency is on the rise. The euro is increasingly being used as an invoicing currency for trade, as a denominator for financial transactions and as a reserve currency held by third party countries. Fourthly and finally, pressure is coming from the EU's enlargement. This provides not only for new member states adopting the euro (as well as old members such as Denmark reconsidering their membership of the euro area), but it also implies that "euro-isation" phenomena will proliferate in countries wishing to join the Monetary Union or somehow come under its economic influence. This strengthens the need for a "key currency" policy in relations with other currency zones.

Opportunity knocks: a single European voice must answer

The time is ripe for Europe, or at least the euro zone, to opt for single representation in international financial institutions and, at the same time, adopt single representation in informal international fora, such as the G7/G8, the G8plus and the G20. The financial crisis has increased the pressure for such a move. The crisis calls for a reform of international economic governance including macroeconomic management. It is in Europe's interests to be an active player in such a process. Speaking with a single voice in monetary and financial matters, in addition to trade policy issues, would not only provide Europe with more clout, but would also force Europe to devote more energy to figuring out where its interests lie in the global system, and what can be done to further them.

Europe's difficulties in identifying a common and effective economic policy hark back to a common trait stemming from the very principle which is at the root of its recent history. Europe's economic policy was devised as a mechanism aimed at achieving a common goal, in terms of growth and welfare, through increased internal integration. And this goal continues even when Europe's policy takes on an explicitly external dimension, as is the case with trade policy. This mechanism assigns a central role to national preferences and works best when such preferences can converge onto the definition of a European preference. But that is precisely the point. If in the post-war years a European preference could be defined bearing in mind internal goals such as peace among member states and economic welfare, in the current environment Europe's interests must necessarily be defined with respect to the global environment. Even more so if the financial crisis represents a structural break in the way the global economy functions.

Chapter 11

Why we need a common European energy policy

Nick Butler

Many people hearing the term "European energy policy" will think of one of the beasts of ancient mythology – a creature much discussed but never actually made flesh; a creature of the imagination not of reality. That first impression is all too accurate. Energy has now been a matter of collective community responsibility for several years and has been widely debated. But nothing which could pass for a comprehensive policy has yet emerged. Furthermore, the absence of a policy is made all the more obvious by the seriousness of the challenges which Europe faces. Two critical issues in relation to energy are both coming to a head: one is focused on demand, supply and price; the other concerns the climate change challenge.

This chapter will examine how this context necessitates and justifies a common energy policy in Europe and will focus in particular on the need for this common policy mechanism to have an external as well as an internal dimension, and on the economic benefits such a policy could bring as Europe recovers from recession.

Crisis one: demand, supply and price

During the last two years the oil price has varied between $ 40 and $ 145 a barrel. The pace and extent of the volatility has exceeded anything seen previously and has contributed to the general climate of global economic uncertainty. Yet, nothing in the underlining pattern of oil supply and demand justifies such volatility. Global demand increased until late 2008, when the recession began to have an impact on consumption, but neither the rise nor the decline was dramatic.

Some blame the volatility on speculation. But all markets involve speculation and traders only speculate when they believe there is some underlying imbalance which justifies the view that prices will go up or down. Speculation has undoubtedly occurred in the oil market over the last two years but the answer to the instability it has caused is to address the underlying problems.

Stepping back from the short term impact of the recession, the reality is that the demand for oil is growing under the pressure of population growth (now running at 10,000 an hour world wide) and the spread of prosperity, especially in Asia. Because of political constraints, the supply capacity necessary to meet that demand is not growing as fast. OPEC states that Russia and non OPEC producers such as Mexico are effectively closed to foreign investment and in times of rising prices have little or no incentive to increase output. The oil is there in the ground, but it is not being developed. There is no physical shortage but without investment the market stays tight and volatile and the price moves up.

The second cause of volatility is the relative absence of spare capacity. In the 1990s and the early years of this decade there were always some 3 million barrels per day of spare oil production capacity. At times, over the last two years the level of spare capacity has fallen to little more than 1 million barrels a day – less than the daily production of a number of countries which are judged to be less than secure for one reason or another. One million barrels a day of spare capacity could not cover serious supply shortfalls from Nigeria, Iraq or Iran.

Normal market processes are not working on the demand side either. Although the sharp increase in prices in 2008 did produce a modest fall in demand in Europe and the US, major substitution away from oil is impossible in the transport sector. But in China and India, the main growth markets, the price to the consumer has risen only modestly because of the protection provided by government subsidies.

These trends look set to continue

In 2008 the International Energy Agency produced a long term forecast which is relatively conservative in terms of growth projections and relatively optimistic in terms of energy efficiency. That forecast suggests that the demand for energy will increase by at least 50% by 2030. A slowdown in economic growth in the short term will have some effect but over time the assumption must be that the country will continue to grow. A 50% increase in global energy demand over the next 20 years is the order of magnitude on which policy analysis should be based.

On the supply side it is important to reiterate that there is no physical shortage; we still have a lot of oil and gas in the ground – 40 years of oil and 70 years of gas. Those are known conventional supplies. Industry experts believe that at least as much again still remains to be found. To that can be added the huge amounts of heavy oil and tar sands which exist in North America and elsewhere.

The problem is location. The places where the oil and gas reserves exist are not the places where they are used and in the last few years there has been a strong growth in energy trade. Today, 50% of all the oil produced in the world every day crosses an international frontier before it is consumed, a percentage that is increasing year after year and within the next ten to fifteen years it will reach 70%, because the major oil-consuming areas – the US, Europe, Japan and now China – all depend on growing volumes of imports, a trend that is now being reinforced by the decline in production from the North Sea and Alaska. The reserves to meet that demand exist but they are to be found in fewer and fewer countries.

We are accustomed to think of OPEC as a permanent entity. But in fact it is shrinking. Indonesia has recently left the organisation and others will do so in the next few years as several OPEC member states cease to be exporters. In some cases, mature fields are in decline but the main reason for the shift is that oil demand within the OPEC countries is very strong. Population growth is high – well above the world average – and prices are very low. A litre of gasoline in Saudi Arabia costs just 5 English pennies.

All this means that the bulk of the increasing volume of exports required to meet the import requirements of the world's leading economies will come from a few countries in west Africa, from Russia and overwhelmingly from just 5 states located around the Persian Gulf: Kuwait, Abu-Dhabi, Iran, Iraq and Saudi Arabia. The implication of the projection of demand and supply by the International Agency for Energy is that by 2020 even if Iraq is producing double today's output and even if Russia is open to international investment, Saudi Arabia will have to produce some 15 to 18 million barrels of oil a day to balance the world market – between 60 and 90% more than today's output. The world market will depend on Saudi Arabia to an even greater degree than at present. Gas supplies too are dangerously concentrated, with 60% of world reserves located in just three countries – Russia, Iran and Qatar.

Crisis two: climate change

Most of the growth in the energy sector in the last 10 years was accounted for by hydrocarbons. According to the consensus figures produced by the International Energy Agency on current trends and under current policies, that will remain the case for at least the next 20 years. The good news is that renewables – wind, solar energy and other sources – are set to more than double in volume terms. The more sobering news is that this means that they will only go from providing around 1% of world energy supply at the moment to between 2 and 3% in 2030.

Nuclear energy will actually lose some of its market share in the next few years because the post-war generation of nuclear stations is coming to the end of their life and the decision on replacing those old stations still hasn't been taken. Also, there is much talk of a new generation of nuclear stations but the necessary investments are not yet being made, while Germany continues to pursue a policy of eliminating nuclear power.

The result of this is that on current policies, hydrocarbons – that is the oil, coal and natural gas which currently supply 84% of energy needs worldwide – will still be supplying a similar proportion of an increased amount of energy in twenty years time. Even if high prices start to reduce the pace of energy demand growth, the reliance on hydrocarbons looks set to continue because of structural factors in the energy market. The capital stock through which energy is consumed is tied into hydrocarbons and that capital stock changes only slowly.

There are still no available substitutes on a commercial scale for the use of oil in transportation – electric cars are still at the experimental stage. Power stations are predominantly designed to run on a single fuel – with most of the new stations opened in Asia in the last decade, for instance, running on coal. The process of transformation and the transition to a low-carbon economy will take time – the worrying thing being that the transition has still hardly begun.

All this means that emissions will continue to increase and the concentration of carbon in the atmosphere will continue to grow. At the moment the level of concentration is around 380 ppm, against 280 ppm before the industrial revolution. On current trends the level could exceed 400 ppm by 2020. The best scientific forecasts say that there is only a 1 in 5 chance of keeping the level below 450 ppm in the medium term and only an even chance of keeping it below 550 ppm in the longer term, which means the end of the century and beyond.

There is a strong consensus that at anything above 450 ppm, the impact on the world's climate will be serious and many believe that impact will start to be felt at lower levels of carbon concentration – impact which seems likely to be felt through extreme weather conditions as well as through increases in temperature.

And all this could happen much more rapidly than is currently expected. Although much of the debate on climate change is centred on the problems we could face in 2050 and beyond, the impact could come much sooner. The volume of summer sea ice in the Arctic has decreased by 50% since 1980 and continues to fall, prompting scientists to warn that the sunlight normally reflected by the ice will be absorbed – increasing the water temperature and reducing the extent of the ice cover throughout the year.

Given where we are today and the established trends in energy consumption – in particular the rapid increase in the use of coal – it does now seem certain that temperatures will rise through this century by around 2°C. 2 degrees is broadly correlated with an increase in the level of carbon concentration to 450 ppm. If we get to 550 ppm, the increase in average temperatures could be much more serious and potentially of the order of 4 to 5°C. As Martin Rees reminds us, a 5°C increase in average world temperatures is the same increase as that which has occurred between the end of the last Ice Age and the present day.

Making the case for a common European energy policy

The key question, therefore, given the context and the challenges examined above, is do we need a European Energy Policy? Is there a need which Europe can address which can't be addressed either by the member states acting alone, or by the free market acting without constraint?

Firstly, it is clear that energy is now a part of national and European security. In a modern and complex society, government cannot simply leave these questions to the market, particularly when as in the case of oil there is no real market – simply political decisions taken by governments in Riyadh, Moscow and elsewhere. Energy is not a normal market and given its importance in the modern economy, government has to be involved.

Secondly, as we have seen over the last year energy prices have a significant economic impact in all countries. Changes in prices have an impact on the trade balance, on inflation and on companies which use energy extensively and therefore on aggregate economic growth and employment. They also have a disproportionate impact on the poor because energy forms a higher proportion of the spending of those on limited incomes. Government cannot ignore any of these impacts.

The next point in favour of a common energy policy is that public intervention is essential in the matter of climate change. The effect of carbon emissions is an externality which as things stand has no cost for most users. Only governments can put a price on carbon. And in all likelihood, only governments can fund the major investments in technologies such as carbon capture and storage which are necessary.

Then, in the case of Europe, there is the simple, inescapable fact that Europe is not self-sufficient in energy. Energy imports are growing. The production of gas from Britain and Holland and of oil from the UK sector of the North Sea is falling. Today Europe imports about 65% of the oil and 40% of the gas which it consumes. In 10 years time if current policies continue, the EU will import about 80% of our oil needs and about 60% of the gas that is consumed. This means that we have a common collective interest in looking to where those imports are coming from. Oil and gas are commodities which are vital to the workings of the economy and to everybody's life. Imagine a day in the life of the European economy without energy. Nothing would move.

Some will say that the EU should simply leave energy issues to the market to solve but that seems an inadequate answer in a world where people are competing for resources, including China and the US, and where the supplies are in the hands of a small and shrinking number of governments directly or through state companies. Nor can things be left to individual member states. It is also a recipe for fragmentation and in some cases conflict, and for impotence in the face of the world's great powers. Europe should therefore work together as one economy, and as a group of nations who have more influence when they act as one than when they act as 27.

A common energy policy: objectives

In simple terms the aim of a European energy policy should be to ensure that there are sufficient supplies of energy at prices which are affordable – that is at levels which do not cause economic damage – and which meet the needs of all of us sustainably without damaging the environment. This means not just having adequate supplies but also limiting dependence on any one source and it means setting in train a sustained, structured move to decarbonise the economy of the whole region.

At the same time we need to understand that a common energy policy should not be about maintaining complete stability of prices, a goal which is unattainable. A common energy policy should not be about uniformity or centralisation or complete control of the energy market by officials and politicians; rather much should and will continue to depend on independent actors in the market: private companies, individual producers, customers making choices.

Nor is a common energy policy about taking public ownership of the energy industry. That is neither necessary nor desirable. Our track record of such public ownership is not of great success, therefore a European energy policy should be about setting a framework within which different players – some but not all of whom might be publicly owned – can operate to achieve the aims of the policy as a whole.

The key to achieving these objectives is, firstly, establishing diverse sources of supply, not accepting that we are going to be reliant on just one or two particular countries for the energy Europe needs and about establishing diverse patterns of infrastructure to ensure that we are never reliant on a single trade route. At the moment dependence is not a serious problem for France or the UK. The countries of eastern Europe by contrast are almost overwhelmingly dominant – to a degree of 90+% – on Russia for their daily supplies of natural gas. That dependence in turn has caused the countries concerned to limit the use of natural gas in their economies and in several cases to continue to rely on coal.

Part of Europe's energy policy should be to diversify the infrastructure we have to bring in oil and gas through multiple channels, and never to rely in any part of the Union on a single supplier and a supply system which relies on just two pipelines. Recently reported Commission proposals for extensive grids across and around Europe are a welcome response to the limits of the current supply system. The establishment through both regulatory steps and through the construction of new infrastructure would help create a single market with completely open electricity and gas grids instead of the fragmented and in some cases barely connected system which exists at present.

As well as diversification, a European energy policy must be concerned with the efficiency of energy consumption, as we are accustomed to using energy in a very wasteful manner. Therefore, the amount used could very easily be reduced – to the benefit of the companies concerned. Furthermore, Europe's performance in terms of energy efficiency may be better than that of the US, but in terms of energy used per unit of GDP the EU is still at least 20% behind the Japanese. Part of a sensible common energy policy would, therefore, be to close this gap – something which is perfectly possible using existing technology.

Following on from this, a programme of development work on alternative and renewable fuels which is backed up by measures to bring those fuels to the market is necessary, as is a European research base to work on the next step in the new generation of energy sources: away from the current dependence on hydrocarbons. Such a research programme is probably best handled through a network of the best European universities working together with real funding to look for the next generation of energy supplies. Over time the answer may prove to be hydrogen, or batteries which can store more power, or advances in capacitors, or it could be in building solar capacity in the Sahara and transporting that electricity through a new line into Europe. Evidently there are many possibilities and the need now is to move from concepts and ideas to material propositions for technology which can actually be used in different countries around Europe.

One key part of research must be about carbon capture and storage. Europe needs a programme – since member states are going to keep using hydrocarbons – to take the carbon out of hydrocarbons and to put it into places where it can be kept and stored safely without going into the atmosphere.

For some, the limit of a common policy is a liberalisation of existing markets – through the break up of the existing integrated and usually nationally based entities which are at the heart of the current energy supply system. The problem is that "unbundling" (the technical term used to describe this process) is an unproven concept and although some reconstruction may be valuable there are risks if the policy leads to fragmentation and the weakening of major players at a time when strong enterprises are needed to carry through a major process of transformation. For this reason, careful regulation may be a better option than the sort of clumsy and destructive "unbundling" which did so much damage to the railway sector in the UK in the 1990s.

The most important problem with unbundling in the European energy sector, however, is that as a policy it is irrelevant to the major challenges we face and will do nothing to address energy security or climate change. Much can be done which would be both relevant and effective. The steps suggested above would all help, and are all steps which the EU can take on the basis of existing technology. There will be a different mix of those steps in different countries according to the base of resources that they have. Some countries have supplies of oil and gas, many don't. Some countries, including France have a great tradition of nuclear power and skills in nuclear engineering, many don't. Some have a powerful research base which can be harnessed. Some, especially the countries of southern Europe, have the potential for the major development of solar power.

Europe, therefore, needs a policy across the Union which matches the needs and addresses the problems we face and which matches the capabilities of different countries to contribute to the solutions. That is why Europe has a Union: not a Union that is uniform where everyone has to do the same thing but a Union that does different things towards a common objective – a common goal with differentiated responsibilities and roles.

The power of a common external dimension

Given the will, Europe could certainly forge a common energy policy. But in itself this would not suffice; a common external approach is also necessary. The EU is part of the world energy market and unless there is a stunning breakthrough on one renewable technology or another, Europe is not going to be self-sufficient in energy and will be reliant on other parts of the world for oil, gas and uranium supplies for many decades to come. Yet though self-sufficiency may not be attainable, the EU should not be passive in the face of external trends, for it is one of the great economic powers of the world and ought to behave as such. The Union ought to be leading the response to these major challenges; a common energy policy must, therefore, include an external dimension.

First, the importance of Russia as a supplier cannot be ignored. The degree of dependence is often exaggerated and may well decline as the supply base, especially for gas, is broadened. Despite this, Russia is likely to remain the largest single supplier of gas to Europe for decades to come; it is undeniably a difficult place to do business but it will be made more difficult if it is treated as an alien society. The Russians have an interest in being part of the world economy and Europe should help to design some creative and positive steps to encourage that aspiration. Therefore, it is not sufficient for Europe to leave the relationship simply as a bilateral dialogue between Germany and Russia, rather the relationship should be based on reciprocity and mutual advantage and grounded in the rule of law. If European companies are able to invest in Russian energy resources, Russian companies should equally be allowed to invest within the Union, provided that they abide by the rules that govern everybody else.

Effective relationships between governments are important but there is also a need to respond to the energy challenges Europe faces in commercial terms. The investment in the resources that are needed in oil, gas, nuclear, renewables and the associated infrastructure will be made by private sector companies investing capital and taking risks in the normal way. What is lacking across Europe is a sufficient number of large scale companies to go out around the world and do this on the scale that is necessary. Companies in the oil and gas sector in Europe are probably still not of a sufficient size to take on all the risks that need to be taken - the risks of going into Russia, into the deep water off the shores of Africa and Latin America, into the Arctic, into central Asia and Turkmenistan, and investing in pipelines, refineries and LNG supply systems.

In the case of renewables, the market is fragmented and there is an urgent need for the creation of diverse enterprises capable of developing a range of renewable energy sources and also capable of spreading knowledge and technology across Europe and internationally. It follows that competition policy in this area should be framed in terms of the scale of the need and designed both to promote and encourage major European companies which can meet the challenges on a world scale.

External energy policy should also extend to the promotion of nuclear and other alternative technologies on an international scale. Nuclear is a key strength for Europe and French companies such as EDF are world leaders, therefore as well as renewing the sector within Europe, nuclear should be seen as a world-wide business opportunity. Many countries around the world need new nuclear capacity and it is important that nuclear development is undertaken safely and under proper regulatory control, Europe is well placed to lead this process. In addition the development of solar power could provide new opportunities for economic links between Europe and the arc of countries around the Mediterranean from Israel to North Africa where the potential for the next generation of solar ventures is made attractive by the high levels of sunlight.

No external energy policy for the European Union can ignore the Middle East. The area is too important to global energy supply either to be ignored or to be left as simply a matter of American responsibility. For reasons reaching well beyond energy policy, Europe ought to be contributing to the process of peacemaking and of building decent societies in the region.

The EU should also continue to lead on climate change, doing all the things that it has rhetorically committed to doing but also going somewhat further, putting substance behind the targets and developing the emissions trading system so that it becomes a model for what the rest of the world should do. The new model should be a single system across Europe which can then be developed into a system that can operate worldwide. Europe as a whole should also follow the model (which has been established in the United Kingdom) of creating a Climate Commission – a publicly appointed authority which sets targets for the reduction of emissions and which guides governments, business and the public on what can and should be done to achieve those targets. That is being done in the UK with some success. That is a start but it would be much better to do the same thing on a wider scale covering the EU as a whole.

The economic dimension

Security of supply and mitigation of the risks of climate change are benefits in themselves. But a common energy policy which involved a managed transition to lower carbon energy would offer wider economic benefits which could be crucially important as member states seek to recover from recession and the financial crisis of the last eighteen months.

Every step in the development of new and alternative fuels, in the creation of new vehicles, powered by electricity, in the establishment of new infrastructure and in the pursuit of energy efficiency will bring both direct and indirect employment. Furthermore, innovation and the application of existing technology can bring new business opportunities. The potential exists not only to transform Europe's own economy but also to create companies which can be global leaders as the rest of world comes to terms with the need for radical changes in the way energy is produced and consumed.

Analysis in the UK suggests that the low-carbon economy can produce 400,000 new jobs, many of them highly skilled and productive. On a European wide basis the potential is significantly higher.

Great game changing rules: a call for EU leadership

None of the possibilities quoted above are unachievable; none of them rely on great breakthroughs in technology nor on any sacrifice of European principles or values. In fact the development of a common energy policy both within Europe and externally would represent an expression of the values on which the EU has been created.

Nonetheless, as well as noting what can and should be done it is worth considering what might happen if a common energy policy is not established. Market forces will keep operating as consumers respond to prices and to the perceived risks associated with supply dependence. The most likely outcome, which is already becoming evident, is a further move to coal as on the grounds of price and local availability. That is what is happening in China and India.

If nothing is done the world will get warmer and warmer, a process which will affect water supplies and agriculture and over time public health. In particular areas serious climate instability will alter and intensify patterns of international migration. Needless to say, the risks are very serious.
As those risks become evident the industrial base required to deliver the transition will develop – but it is much more likely to develop from an American rather than a European foundation.

Recent months have demonstrated once again the interconnectedness of the global economy and the need to anticipate and forestall risk. The global financial system, as we have seen, is not self correcting. Active public policy is essential – not to control every detail of economic life – but to set the ground rules within which individuals and enterprises can operate to the benefit of all. The breakdown in the financial system is leading to a fundamental re-examination of the rules of the game. That re-examination should be extended to the energy market where the risks of insecurity and irreversible environmental damage are growing. Europe's challenges are not unique and cannot be solved in isolation. In a complex and dangerous world the need for European leadership has never been more important.

Chapter 12

Energy and environmental policy: options for the future

Dieter Helm

In the aftermath of the Second World War, European integration had a wide and immediate appeal on the continent, if not in Britain. Europe had experienced two devastating wars, themselves premised on the Prussian victory over France in 1871. Alsace and Lorraine, security in the Rhineland and the great industrialisation of western Europe all had energy security at their core.

Not surprisingly then, the European Coal and Steel Community and Euratom figured first in the steps towards a Common Market. As the economic recovery gained momentum, Europe moved on to a customs union – a kind of large-scale Zollverein – and the preoccupations of the Common Agricultural Policy.

Since these early days, it is fair to say that energy has not figured large in the EEC and then the EU. Energy was largely taken for granted, and even the great OPEC shocks of the 1970s did not elicit much by way of a European response. Indeed, on the contrary, the International Energy Agency was set up to address OECD-wide energy concerns.

Much has changed. Natural gas has become an important fuel, and hence dependency on Russia has arisen as an issue. Then there is privatisation, liberalisation and competition, which began to unwind the national energy policies and (for a while) the national champions. A Europe-wide internal energy market appeared possible. And then environmental effects from energy production and consumption became apparent – first through acid rain and the damage to Scandinavian lakes and Bavarian forests, and then climate change.

This change of circumstances has proved a challenge which so far the EU has failed to meet with much beyond token measures. But it also provides a very significant opportunity to craft a new rationale. Neither energy security nor climate change can be solved at the national level. Both are at least European in domain, and both require an ability to negotiate at the global level. They involve Europe-wide infrastructure, Europe-wide markets and European foreign and defence policy.

This chapter sets out the context for this emerging European agenda, explains why Europe's policies on energy security and climate change have so far not matched the scale of the challenges it faces, and provides a series of proposals to deliver better outcomes for European citizens.

The European energy market — what makes it a European policy matter

Whether an issue is a matter which requires intervention at the European level depends on first identifying clear and serious ways in which markets left to their own devices fail to meet public needs, and second identifying whether the domain of these failures and their solutions is local, national or European.

It has long been recognised that energy markets require significant intervention, despite the enthusiasms of some on the political right in the 1980s and 1990s. For most of the second half of the twentieth century the failures were deemed so serious as to mandate state ownership and statutory monopolies. These market failures included: investment and the need for commitment to meet the sunk costs (the private sector was thought to under-invest, in part for fear of *ex post* appropriation); market power and monopoly requiring price regulation; social cohesion and network extension to rural areas; the provision of energy as a basic social primary good (part of the wider welfare state); and the complementarity to the economy and its competitiveness.

There were also important issues of coordination in a context of a desire for national self-sufficiency that played a significant part in energy policy, with domestic coal industries having had key roles in Britain, in Germany and even in France. Balance of payments considerations mattered greatly too, especially when exchange rates were fixed.

In the 1980s, this consensus on the need for state ownership and monopoly began to crack. For, although few doubted that there were serious market failures, the scale of government failures were becoming so great as to mandate a fundamental rethink. Energy policy had become captured by interest groups: trade unions, local politicians and the industries which provided the capital goods for the sector. Prices reflected political concerns, and these in turn reflected the impact of lobby groups. Most formidably, in Britain the government was brought to its knees by the coal miners.

But there were several further coincidental developments which made the time ripe for a (radical) change in direction. First, information technology was sufficiently revolutionised to allow trading in energy – and power station dispatch and system coordination – possible without central planning. Second, energy prices collapsed in the 1980s. Third, the stranglehold of coal was broken with the coming of natural gas. And, finally, there was the North Sea. These fundamental changes all occurred in the context of the great capitalist expansion of the late twentieth century, with its accompanying ideological faith in markets. Having been in retreat since the Second World War, markets were back in fashion – intellectually first, and then politically too.

But whilst the excess supply and low fossil-fuel prices of the 1980s and 1990s provided a fertile context for the new ideas about energy and markets, other longer-term trends were developing, and would be felt in the first decade of the twenty-first century.

The first of these was the consequences of the dash-for-gas – the displacement of coal by gas as the fuel of choice for industry and then electricity generation. Whilst the North Sea was producing surpluses, these effects looked benign, but by the post-2000 period, the gradual dependency on gas imports was beginning to have its effects, not least in resource-poor countries like Germany, but in Britain too. It gradually dawned on Europeans that Russia was becoming dominant in the energy relationships. Whilst Norwegians, Algerians and Libyans might add to supplies, the stranglehold of Russia began to loom over Europe. Local disputes in "far away lands" – like the Ukraine and Georgia – took on an unexpected importance.

The second was the Europe-wide impact of pollution. Acid rain was the first, and because it was very much a regional problem with effects that local populations could immediately see – acidification of lakes and images of dying forests with all their romantic connotations – action followed fairly swiftly and with considerable success. The Large Combustion Plants Directive (LCPD) used the traditional regulation toolbox to tackle the emissions on a plant-by-plant basis. European environmental policy worked.

But acid rain was easy compared with climate change, where there are few immediate visible signs analogous to acid lakes and dead trees. Climate change required a unique combination of action at home and persuasion abroad – to slow emissions in Europe and persuade the US, China and India to follow suit. The Kyoto Protocol came out of the United Nations Framework Convention on Climate Change (UNFCCC), but it became a European priority. Enormous political capital was expended in making it operational and then in designing and implementing the EU Emissions Trading Scheme (EU ETS). Yet for all this effort, achieving the Kyoto target makes almost no difference to climate change. It is but a molehill against the scale of the decarbonisation of the world's economy required, given the rise of China and India, and the projected increase of the world's population by 50% by 2050. Despite Kyoto, world emissions of CO_2 are projected to increase substantially by 2030 – not even to stabilise.

Thus, at the end of the great capitalist expansion of the late twentieth century, the energy and environmental scene looks much uglier than the policy-makers in the 1980s and 1990s envisaged. Gone are excess capacity and what had seemed permanently low fossil-fuel prices. Instead, Europe faces oil prices shot up to as high in real terms as they were at the end of the 1970s before moderating in the face of global recession, a large electricity generating capacity gap as old power stations come to the end of their lives, growing dependency on Russia, and real concerns about security of supply sufficient to lead many European countries to consider building new nuclear and coal power stations, and a very difficult CO_2 position.

For European citizens, climate change is an important political imperative, embedded in political systems and often represented by parties which hold at least the implicit balance of power. But the impact of (much) higher prices after 2000 without the ability to cross-subsidise, which had been a hallmark of the statutory monopolies, had by the middle of this decade brought hardship as significant numbers fell into fuel poverty.

Industrial competitiveness is affected too. And to cap the gloomy picture, the prospect of interruptions in supplies, and price spikes, has begun to reappear. Russia's invasion of Georgia, the vulnerability of Ukraine and Russia's response to missile defences, and NATO's expansion have added greatly to nervousness across Europe. The interruption of gas supplies via Ukraine for three weeks in January 2009 was a decisive wake-up call.

European energy policy to date — an (almost) abject failure

Whilst these fundamental challenges have been developing, the EU has concentrated on three separate agendas: the internal energy market and the liberalisation of electricity and gas markets; renewables, energy efficiency and the EU ETS; and the attempt to get Russia to ratify and implement the Energy Charter and to develop the EU–Russia Energy Dialogue through the Partnership and Cooperation Agreement (PCA) framework. The first has been agonisingly slow to implement; the second has been demanding but to a significant degree ineffective; and the third has been arguably actually counterproductive. And, in the meantime, the key challenges have been neglected.

The internal energy market proposals grew out of the programme to *complete the internal market* by the end of 1992, and initial proposals surfaced as early as the mid-1980s.[1] However, it took a decade to reach the compromise reflected in the weak electricity and gas directives (the 1996 and 1998 directives),[2] and it is only in the middle of the current decade (almost 20 years later) that liberalisation has been effected. The result, however, has not been a competitive market. On the contrary, whilst the EU energy directorate in its various guises has pursued liberalisation and competition, the competition directorate has facilitated (and in some cases actually encouraged) a massive wave of mergers across Europe, with the result that a very small number of companies now dominate the European energy market. Far from breaking down national champions, EDF, RWE, E.ON, GDF-SUEZ and ENEL bestride the European landscape, with a number of large second-division companies joining the consolidation process. As a result, it is hard to argue that there is much genuine competition within and between European national markets *as a result of the European actions* (though national policies may have had more effect in national markets).

It might, at first glance, seem that the EU has been more successful on climate change, following on from the successes on acid rain. Appearances can be deceptive, however: carbon emissions have not changed significantly *as a result of European climate change policy*. There have been significant reductions in some countries – notably in Britain – but these have been for other reasons, including the contraction and closure of coal industries across Europe and the switch to gas, and de-industrialisation, with energy-intensive industries migrating to the Far East. Kyoto targets have proved a tough challenge despite their modesty, and they have been further eased by buying in carbon credits. Kyoto measures carbon emissions in a flattering way too: it measures home carbon production, excluding aviation and shipping. It does not measure carbon consumption. Hence, by contracting out heavy industries to China and then importing the products, Kyoto counts this outsourcing as if emissions had actually fallen.[3] So achieving Kyoto is not a big deal in itself, and all the while *global* CO_2 concentrations continue to climb.

Then there are the ways in which the Europeans have chosen to reduce emissions, through heavy reliance on renewables and energy efficiency. The former has proved very expensive and slow; the latter just slow. Large-scale technologies, such as carbon sequestration and storage (CCS) and nuclear, have been largely absent from European policies. Indeed, the latter is still ruled out in Germany. Not surprisingly, therefore, the US, with its major technology drive, has probably done at least as much as the Europeans to address the scale of the climate change problem without Kyoto.

On Russia and energy dependency, the policy approach has been at best naïve. Europe has treated Russia for much of the 1990s as if it were a candidate for membership, expecting it to converge on European approaches to liberalisation and competition. The Energy Charter and the Transit Protocol have been the main instruments, and whatever the precise legal forms of these agreements, the Europeans have argued that Russia should open up its pipelines to third-party access, and allow freedom for investment upstream inside Russia.[4]

Not only has this proved naïve and ineffective, but by concentrating on telling Russia how to run its internal energy market, the Europeans have failed to address the steps which would make its own market more resilient and therefore increase its bargaining power. The agenda set out at the Hampton Court summit in November 2005[5] – including completing electricity and gas grids and strategic gas storage – has not been determinedly implemented, whilst the effect of the renewables programme and the neglect of nuclear have meant that gas dependency has been growing, and will continue to do so. Finally, the failure of the Europeans to develop foreign (and indeed military) policy capacities to back up pipelines to the Caspian, the reluctance to engage with Turkey (and also Georgia), and Germany's developing special bilateral relationship with Russia (exemplified by the Baltic Pipeline and Schröder's chairmanship of it) have left Russia in an increasingly powerful position. After the invasion of Georgia, Caspian producers will understand that sending gas north via Russia, rather than west via Georgia, may be a better way of maintaining their own national security.

Taken together – the internal market, the climate change policies and the security agenda – in all three cases European policy has been largely a failure, and arguably on the security front an abject one. The Commission has not appreciated this, however, and for its two main energy packages – the January 2007 unbundling proposals,[6] and the 2008 climate change proposals[7] – the old agenda remains in the driving seat. Yet in each case it is not rocket science to think through practical European solutions, and it is to these we now turn.

The internal market and the 2007 January package

The internal market is a good idea, but like all good ideas it needs to be tempered to practicalities. What is missing in the internal market is the *physical* interconnections: the creation of internal European electricity and gas grids. The Commission's emphasis has been on creating a market *before* the physical framework is in place – to have competition without connectivity. Thus, rather than spend the 1990s and the early years of this decade on the grid project, it has spent it on liberalisation first. Not surprisingly, the result has been not much competition, except in the national markets where the infrastructure is already in place. Competition between European countries has been limited.

The January 2007 package has taken this one step further – to try to force through physical unbundling of existing networks. To support its case, the Commission produced a devastating critique of the extent of competition in European energy markets[8] – but drew the conclusion that this was due to bundling rather than the absence of interconnections or the market concentration as a result of mergers. To be fair, the Commission has tried to promote interconnections, but largely on a bottom-up basis, focusing on bilateral links rather than the European network as a whole. Belatedly, as the unbundling proposals have run into the predictable political obstacles of Germany and France, it has changed the rationale too. Now unbundling is supposed to promote the formation of regional and then European grids.

This approach has some merits, but it is wholly inadequate to the challenges and economic opportunities that network integration and development offer. European grids offer major economic efficiency gains because they reduce the portfolios of excess capacity that the systems need to hold to manage peak demand (so there is a very significant competitiveness advantage); they enable the competition that the Commission wants to encourage; and they enhance security by making mutual support a physical reality. European grids would in the process greatly improve the capacity to use the existing system more efficiently and thereby effect significant reductions in CO_2 emissions too.

The 2007 package is a fairly feeble step in the required direction, and it will take years for the regional and eventually European grids to be realised. Rather the Commission would be better advised to start from the other end – to urgently devote considerable resources to completing the European networks and to drive the regulation and management of these networks from the top down – to treat them as European systems, rather than a patchwork of national ones. The great achievement in the middle of the twentieth century was to take the patchwork of local and municipal utilities and create national grids. An analogous effort is needed now, and as a matter of urgency.

The 2008 January package on climate change

Whereas the 2007 unbundling package is ambiguous in its effects, the 2008 climate change package is of greater concern, if only for the sheer scale of its implications for the European energy markets. The 2008 package is very much a political one – the clue is in its catchy '20 20 by 2020' sound bite. It envisages that by 2020, emissions will be reduced by 20% overall, and that this will be achieved through three main mechanisms: a 20% renewables target, a 20% energy efficiency target, and the EU ETS. It would indeed by a miracle if all these components added up to the magic 20 number.

Examined in closer detail, the most significant part is probably the 20% renewables target. Because this is the share of *total* energy, it translates into a massive expansion of wind power across Europe. Even for Britain, with a more modest 15% target, this may translate into an increase from the current share of wind of around 5% of electricity generation to as much as 35–40% *in just 11 years*. Whilst such a target could be achieved across Europe, it would require the sort of intervention that was seen when the Europeans moved from peace to wartime economies in the mid-1930s. As yet, nobody is arguing that this will be achieved. Thus the target is not credible.

But that does not mean that it will not have effects. A dash-for-wind before renewable storage technology catches up will also mean a dash-for-gas (or, worse from a climate change perspective, a dash-for-coal) to back up the new wind capacity and replace the large-scale closures of existing old power stations. It means, in effect, that just when the concerns over dependency on Russian gas are rising up the agenda – and Europe's import dependency is growing rapidly – the Europeans will deliberately ratchet up that dependency.

Other parts of the 2008 package have greater merits. Energy efficiency in particular has an important part to play in any security and climate change policy. But it remains to be seen what will drive energy efficiency. Price – and in particular sharp price shocks – are much more likely to change behaviour than European policy – as indeed they did as a result of the oil price rises, though these have now substantially reversed. The credit crunch is also reducing consumers' ability to pay as real incomes stagnate or fall. As witnessed after the 1979 oil price shock, the energy ratio improves as a result of price signals, and this improvement may be sustained even if prices then fall back, as they did in the mid-1980s.

The EU ETS has obvious merits too: it is market-based, and it provides a mechanism to broaden out action beyond the EU to the US in particular. However, it is far from perfect. It will run to 2020 only, while most of the supply-side responses and technologies will have their impact *after* 2020 (including nuclear, CCS and non-wind renewables). And it could easily descend into a pork barrel for cash-strapped governments. Already in Britain the revenues are variously earmarked to pay for renewables and reduce fuel poverty.

The missing components

Whatever the merits of the particular components in these two packages, the most important point to note is what they leave out – what is missing. Not only are both packages deeply flawed, but they are in large measure sideshows which reflect more the political concerns of member countries and the European Commission, rather than the needs of a robust European energy policy.

These missing components are relatively easy to identify, and hard to develop and deploy. First and foremost is the external dimension – to build up an external energy policy to deal with gas import dependency from Russia. As noted above, to date the steps have revolved around the Energy Charter and the PCA – in effect telling Russia how to run its own internal market. This has failed: Russia has continued to monopolise its gas pipelines within Gazprom and to follow the overwhelming international trend towards nationalising its resources and reserves. Whether this is in Russia's own interests is debateable (although it has a core rationality and is very similar to the approach taken in developing British and Dutch North Sea gas). But for Europe it is a fact which needs to be recognised and responded to. There is no real chance that Russia is going to change its energy policy.

It is also a fact that, for Russia, energy policy and foreign policy are intimately linked, and the main components of Russian foreign policy towards its near neighbours to the south, south east and the west are very clear. The Caspian States on the eastern shore will increasingly realise that it is in their narrow security interests to send the gas north through Russia, rather than across the Caspian and west through Georgia and Turkey. Ukraine is likely to continue to feel the pressures on its energy prices and supplies, not least as the issue of the Russian naval base at Sebastopol comes to a head.

The correct response to this external challenge is in three parts: mutual protection backed by foreign and military support; diversification away from gas dependency in general and Russian dependency in particular; and increased internal resilience to shocks. The first part is almost entirely missing – as witnessed, on the one hand, by the failure to recognise that the Nabucco Pipeline proposal could not be left entirely to private companies and market forces, but needs to be protected by a foreign policy and security framework and, on the other, by the bilateral approach of Germany towards Russia, notably in respect of the Baltic Pipeline.

Contrary to much European Commission rhetoric, renewables are not much of an answer to the second missing element – security of supply and diversification. As noted above, they may actually make matters worse by inducing a further dash-for-gas. Serious diversification requires the Commission to deal with the questions of nuclear and coal head on. The former has remained a national competence, and there is not even a European-wide licensing and safety regime. And whilst renewable generation is protected from markets through explicit EU quotas and obligations, nuclear is not.

On coal, the Commission has largely evaded the issue – notwithstanding that coal is the most obvious and immediate large-scale means to increase security. It does, of course, have major environmental consequences, but if the Commission is serious about climate change, it must recognise that the rising coal-burn in China and India in particular will undermine any global climate change strategy unless CCS technology is advanced rapidly. Europe has the shallow and depleted North Sea fields, and coal stations around the perimeter. If the EU was serious about global warming, coal and CCS would figure much higher up its agenda than the commitment to the demonstration plants indicates and would be at the centre of its 2008 package. The fact that the impact of the EU ETS and the LCPD will fall heavily on coal generation in exposed eastern European countries like Poland (with 90% coal-fired electricity generation) is of particular concern to those on the Russian front line.

The third missing element is internal resilience, and this has two main parts: strategic gas reserves and integrated European electricity and gas grids. The former are expensive and resisted by oil and gas companies who worry about the impact on prices and profits. The latter, as we have seen, has been approached in a piecemeal bottom-up fashion. Both policies were endorsed at the Hampton Court Summit, and carried over into the 2006 Green Paper.[9] Neither has made much practical progress. Any mutual support arrangements – a further missing element – depend on the ability of networks to carry through the support. These still remain largely nationally based and bilateral, not European.

Stepping forward with intent

There are some signs that the first tentative steps towards formulating a credible European energy policy are being taken – to recognise the inadequacy of existing policies and to appreciate the urgency of the challenges that Europe now faces. It takes a crisis to get energy policy changed, and Europe now has the beginnings of a crisis. Russia's invasion of Georgia has proved cathartic and the interruption of supplies to Ukraine in January 2009 removed any lingering complacency. Over the next decade there is every indication that it will get much worse, as existing old power stations close down, as gas dependency rises, and as the full costs and consequences of the dash-for-wind unfold. As, if and when energy prices fall, complacency could easily resurface – reinforced by the collapse of demand as a result of the recession.

Whilst there is this recognition of policy failure and trouble ahead, the European Commission has a number of steps it could usefully take to implement the Hampton Court agenda. Completing the grids, strategic gas storage, mutual support and common nuclear licensing are measures which should be introduced quickly. In addition, the EU needs to confront the more difficult technologies – nuclear and coal – and recognise that these options require a careful rethink of the market designs – in terms of both the EU ETS and its limited horizons and a level playing field with other technologies, notably wind. CCS in particular needs to be taken much more seriously.

Chapter 13

Climate change action: can the EU continue to be a leader?

Laurence Tubiana and Matthieu Wemaëre

The science now clearly proves that global warming results from increasing greenhouse gases in the atmosphere due to human activities. It is also evident that climate change is already happening and will have a large and irreversible impact if global temperature continues to rise. In order to combat this challenge, ambitious emission reductions plans need to be set and action must be guided by science.

The urgency of the climate change challenge

According to the IPCC 4th Assessment Report (2007), a 1-2°C increase in global temperature above 1990 levels (about 1.5 to 2.5°C above pre-industrial levels) poses significant risks. The debate now is about how to manage risks by containing global average temperature increases within such limits that they do not have a dangerous impact. In order to have a reasonable chance, global emissions need to be reduced by at least 50% by 2050. This implies that global emissions should peak in 2020, developed countries should take on mid-term emission reduction targets (by 2020) in a range of 25% to 40% and long term targets (by 2050) in a range of 80 to 95% below 1990 levels, and developing countries should take ambitious mitigation actions so as to ensure that emission levels are significantly less than the business as usual scenario.

This will require a complete shift in our production and consumption patterns and ways of life. Given the context of the economic crisis, moving towards a low-carbon economy can provide an opportunity for all countries to engage in sustainable development while enhancing energy security, independence and peace thanks to innovation, economic diversification and an equitable distribution of resources. For that to happen, key choices will have to be made in next five years that will be instrumental in achieving lower emission goals. Conversely, if these decisions are delayed, climate change may have a disastrous impact. If global emissions peak beyond 2020, this would imply much steeper reductions and thus significantly increase the danger of exceeding the 2°C objective. Therefore, action must be taken now and should be based on the precautionary principle.

Need for international cooperation

Given the global scale of the challenge, no one country can address it alone, hence the need for international cooperation. The multilateral framework for this was set forth in the 1992 UN Convention on Climate Change (UNFCCC). Its ultimate objective is to stabilise greenhouse gas emissions at a level that would prevent dangerous effects on the climate system. The 1997 Kyoto Protocol was a first step in responding to the need for reducing emissions, by putting absolute quantified targets on the emissions of industrialised countries. However, it is soon to lapse (in 2012) and the level of ambition (-5.2% of global emission reductions as compared to 1990 levels) is not enough in order to meet the long-term goal. At the Bali UN climate change conference in December 2007, parties to the UNFCCC therefore agreed to launch a comprehensive negotiating process, referred to as the Bali Roadmap. This process is set to conclude in December 2009 at the UN climate change conference in Copenhagen. The Copenhagen Conference will be a unique opportunity to set ambitious mid and long term targets based on scientific evidence. The agreement should be legally binding so as to ensure political responsibility and accountability of each nation, keeping in mind the principle of common but differentiated responsibilities and the respective capabilities of developed and developing countries.

In particular industrialised countries, including the EU, have an increased responsibility for their greenhouse gas emissions since 1750. They should therefore take the lead in fighting against climate change while providing support to developing countries, helping to advance mitigation actions, entail co-benefits and adapt to climate change, especially in the most vulnerable countries. There is an urgent need for global action, cooperation and solidarity.

This will require strong leadership in all international negotiations, in particular within the UNFCCC. The Copenhagen Conference will not mark an end to this process, it is likely that implementing measures will have to be negotiated up until 2010 or 2011. In addition, the adequacy of commitments will need to be reviewed periodically. Therefore, the leadership must be long-lasting so that the political momentum can be sustained. And, to be credible, any international leadership must be underpinned by ambitious policies and measures at a domestic level.

Can the EU close the gap?

While international relations experts remain divided over the existence of a European leadership in international affairs, there is significant literature on the EU's role as a global actor which emphasises the importance of the environmental leadership role that the EU can assume. There is also literature that argues that the EU has demonstrated leadership particularly in the climate change regime. Having said that, does the EU fill in the gap between "aspiration" and likely achievement on climate change action? One would like to believe so. However, examining the scope and expected outcome from EU climate change policies, and also at the way climate change is considered (or not) in other policy areas (for instance transport, agriculture, external relations and cooperation, and waste management) may lead to some scepticism. In fact, much more needs to be done by the EU to further accelerate its transition towards a low-carbon economy.

The EU has been claiming recognition of its leadership in combating climate change since the early 90s. Such "aspiration" is real and sincere in many ways. In 1996, even before the adoption of the Kyoto Protocol, the EU Council of Ministers put 2°C forward as the maximum limit for rise in temperatures. It has continued to support ambitious targets for the climate regime, developed an integrated though comprehensive set of policies and measures identified through the European Climate Change Program (ECCP) launched by the Commission in March 2000, showed concern over the environmental integrity of Kyoto Protocol's flexible mechanisms (supplementarity of international offset credits for complying with emission reduction targets, reluctance to use forestry credits because of temporary and reversible nature of sequestration through forestry activities) and developed the first mandatory regional emissions trading scheme in 2005 with the launch of the EU Emissions Trading System (ETS) that puts a price on carbon for key EU emitting sectors (power generation and energy intensive industries).

As a result, the EU is well-positioned for meeting its quantified emission reduction target under the Kyoto Protocol (-8% of GHG emissions as compared to 1990 levels) in 2012: by 2010, total EU-27 GHG emissions are projected to be about 10.1% below base-year levels.[1]

Obviously, all recent EU policy initiatives tend to be designed as a blueprint for international climate negotiations. In effect, the EU has been publicly ambitioning no less than *"Winning the battle against climate change", "Leading global action to 2020 and beyond"* etc. At the Spring European Council of March 2007, heads of states and governments agreed to endorse a set of targets, commonly referred to as the "20 – 20 – 20":

- A legally binding target of 20 % reduction of GHG emissions by 2020 (30% in case an international agreement on climate is concluded), with a long term target of GHG reduction of 60-80% by 2050;

- A legally binding target of 20% share of renewable in EU primary energy consumption by 2020 (and 10% share of biofuels in transport fuel use by 2020);

- An indicative target of 20% energy efficiency improvement by 2020;

A big step forward: the EU Climate Energy Package

In order to implement the conclusions of the Spring Council of March 2007, the EU adopted the Climate and Energy Package in December 2008 which reflects the -20% unilateral reduction target by 2020 to be increased to -30% if the Copenhagen agreement is ambitious enough. With this, the EU intends to be an example, especially to other industrialised countries who should play a leading role in the fight against climate change. It is noteworthy that it was adopted in December 2008, when the French Presidency of the EU was keen to push the package through in order to lead by example at the Copenhagen Conference, and convince international counterparts to engage in an ambitious post-Kyoto climate regime.

The package comprises several legislative measures aimed at achieving the set targets.

Firstly, it amends the EU ETS Directive (through Directive 2009/29) to fix an ambitious cap on emissions of ETS sectors (-21% as compared to 2005 emissions), which corresponds to a target of -11% as compared to the emission reduction efforts required between 2008 and 2012. It provides a predictable trend-line through a linear decrease in delivery of allowances up to 2020 (annual decrease of 1,74%) and beyond (review of the linear factor in 2025). Auctioning becomes the allocation method, in principle, for sectors able to pass through costs (power sector, except district heating and efficient co-generation). At least 50% of auction revenues should be used by member states to reduce emissions, fund adaptation measures, support research and development, develop renewable energy and "environmentally safe" carbon capture and storage including in developing countries, increase afforestation, transfer technologies and facilitate adaptation in developing countries, finance R&D in energy efficiency and clean technologies, support energy efficiency measures and address social issues in low and middle income households.

Secondly, the Effort Sharing Decision sets individual targets for member states for the "non ETS sectors" (diffuse sources, including small-scale emitters in sectors such as transport, buildings, services, small industrial installations, agriculture and waste), which currently represent some 60% of total emissions in the EU. While national targets differ, overall the Effort Sharing Decision fixes a -10% of GHG emissions as compared to 2005 levels.

Thirdly, the Renewable Energy Directive sets a 20% target for renewable energy share in final energy consumption by 2020, which is distributed among member states on the basis of a burden sharing approach: half of the burden is calculated on a flat rate increase in the share of renewable energy whereas the other half is weighted by GDP, modulated in such a way that national starting points and efforts already made for member states that achieved an increase of above 2% between 2001 and 2005. 5.5% is added to the modulated 2005 share of renewable energy for every member state, and the remaining effort (0.16 toe for each person in the EU) is weighted by a GDP/capita index, then multiplied by each member state's population. These two elements are added together to derive the full renewable energy share of total final energy consumption in 2020. Lastly, an overall cap on the target share for renewable energy in 2020 is applied for individual member states.

Fourthly, the package provides for a Directive providing the enabling regulatory framework to manage environmental risks associated with carbon capture and geological storage (environmental integrity through the life-cycle of the plant, site selection up to post-closure, corrective measures in case of carbon leakage) and removes barriers in existing legislation. This legislation is supplemented by the inclusion of carbon capture and storage (CCS) for Phase III (2013-2020) of the EU ETS: CO_2 captured and stored will be considered not emitted under the ETS, operators capturing CO_2 through CCS will not have to surrender EU allowances for those emissions and can instead bank them for carry over or sell them on the market.

Fifthly, The Package comprises a Regulation aimed at reducing by 2015 average CO_2 emissions from new passenger cars to 120g/km, and a Directive setting new environmental quality standards for fuels and biofuels, which are expected to reduce by 2020 GHG emissions from fuels by 6% over their whole life cycle.

Finally, this Package did not provide for specific measures to implement the indicative target of 20% energy efficiency improvement by 2020. However, additional measures were proposed by the Commission in November 2008 to follow up the Energy Efficiency Action Plan of 19 October 2006 that identified 75 actions to promote energy efficiency improvements in the context of its sustainable production policy (eco-design, energy labelling, review of EMAS and eco-labelling scheme, greening of public procurement).

According to a statement made by Commission President José Manuel Barroso, the package *" is part of the solution both to the climate crisis and to the current economic and financial crisis. It represents a green "new deal" which will enhance the competitiveness of EU industry in an increasingly carbon-constrained world. Moving to a low-carbon economy will encourage innovation, provide new business opportunities and create new green jobs."* Reducing the burden of energy consumption (energy efficiency should save 800Mt CO_2 per annum in 2020), strengthening energy security (renewable energy should save 600Mt per annum) and creating new jobs would make the transition to a sustainable low-carbon economy a reality while maintaining living standards and competitiveness. The Climate and Energy Package testifies to the EU's confidence in its capacity and determination to reduce emissions and change energy production and consumption patterns with a "strengthened set of far-reaching legislative tools to share with the rest of the world".

These measures should translate into a robust carbon price that creates incentives to reduce emissions. It should make cutting-edge innovation economically viable (Carbon Capture and Storage, for instance, is assumed to be commercially viable within a €30-50/ton CO_2 range[2]) while making fossil fuels less competitive than cleaner or renewable energies. Auctioned emission permits instead of free allowances should strengthen the carbon price signal while limiting unexpected distributive effects and "windfall profits" in the power sector and proceeds in the range of €20bn p.a.(considering 20 €/tCO_2) would support climate policy measures in the EU and worldwide. International offset credits remain in the scheme under quantitative and qualitative criteria, notably to avoid flooding the EU ETS with cheap credits in case failure of an international agreement would lead to oversupply of carbon credits.

Looking ahead: a problematic path

A high carbon price will be needed to provide a strong incentive for the deployment of renewable energy in a cost effective manner. However, some modelling findings (eg POLES) show that the renewable energy target of 20% by 2020 is very hard to reach and very expensive to achieve – even with 75€/tCO_2. However, achieving the 20% renewable energy target will depend on a number of factors, not just a high carbon price.

First estimates of the Commission (respectively 800 Mt and 600 Mt of CO_2 savings for energy efficiency and renewable deployment) seem therefore ambitious compared with the actual capacity of these policies to deliver. Figures provided by the Primes model for the impact assessment of the climate and energy package lead to more conservative figures (see page 161).

Energy efficiency improvement is indeed critical to achieving the renewable energy target. In effect, without real improvements in energy efficiency, reaching the desired levels of penetration of renewable energy in the supply mix will be more difficult and expensive. In addition, improving energy efficiency in trading (EU ETS) sectors would take some pressure of internationally competitive industries if goals are met strongly in domestic sectors.

While the 20% GHG reduction target seems achievable unilaterally, it is not consistent with the EU aspiration to limit the increase in temperature to 2°C, which requires reducing emissions by 30% by 2020, and 80% by 2050. The increase to a level -30% target as compared to 1990 levels will only be endorsed by the EU in the context of a "fair and ambitious global deal", e.g. provided that other developed countries commit themselves to comparable efforts in Copenhagen. In other words, the target proposed by the EU is actually made conditional upon efforts to be made by other developed countries. The reason is to not put too much burden on EU industry if foreign competitors from OECD countries are not subject to equivalent carbon constraints. From this perspective, EU leadership on climate change is also driven by competitiveness concerns, not just by environmental considerations.

If the EU pursues a -30% target, it would have to reduce emissions domestically by more than 20% under 1990 levels compared with an estimated 15% effort under the 20% target. Such a leap would require fully using the potential of renewable energy, energy efficiency, carbon capture and storage and offset mechanisms. Yet the performance of carbon capture and storage is uncertain, and achieving the emissions reduction target domestically if these mechanisms failed to deliver would require quick fixes. More renewable energy is an option although even reaching the 20% target is not cost effective and requires major political action. Increased energy efficiency targets could help if a clear and attractive framework emerged.

Different sectors and scenarios

Achieving the -30% target would lead to greening the European economy. It would require an in-depth transformation, but the challenges would greatly vary between sectors because they follow different dynamics.

The power sector and the energy intensive industries are compelled by a cap and trade scheme (the EU ETS). This system reveals an explicit CO2 price. These sectors are internalising the CO2 price signal in their production choices, and in the longer term, in their investment decisions. In these sectors, providing predictability on the long term price signal is crucial to secure investment choices towards low-carbon options.

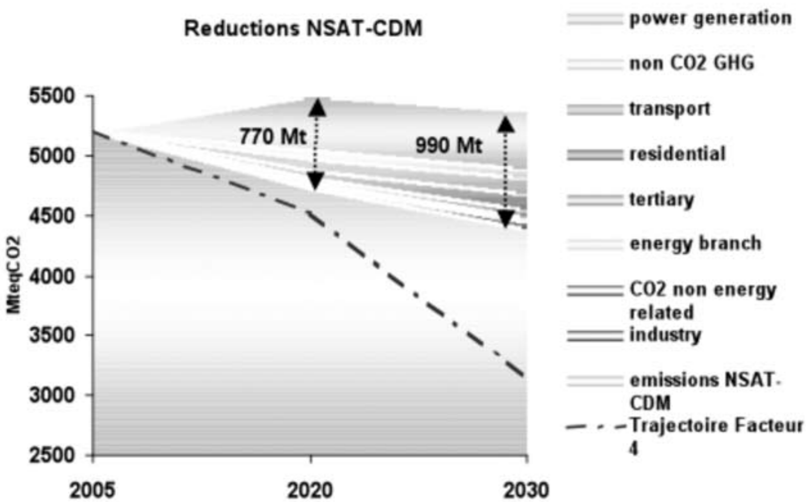
In non-ETS sectors such as transport, agriculture or buildings, emissions reductions are not only relying on the introduction of low carbon technologies but also on organisational choices. Moving to a low carbon pathway in these sectors would require transformations in organisational modes, transportation, infrastructure choices, and long-term shifts in behaviours. A set of policies and measures is necessary but implementation would depend on existing infrastructure and its implications for socio-economic organisation.

Models can provide relevant illustrations to picture the magnitude of the sectoral transformations that would be necessary to shape a low-carbon society by 2050. The results provided by the model PRIMES shows the challenges for operation and investment choices in the different sectors, comparing a business as usual (BAU) scenario with a 20% emission reduction scenario by 2020.

The scenario achieves 15% emission reduction domestically (or around 770 Mt), the difference is compensated by the use of *offsets* (Clean Development Mechanism and Joint Implementation credits). The power sector is the key sector to provide substantial reductions. It contributes to almost 60% (or 450 Mt) of the total reductions in 2020 compared with the BAU. This implies radical changes in the power production patterns, in particular, a reduction of fossil-fired plants (-18% or an estimate of 85 MW in installed capacities compared with BAU in 2020) and a steep increase in low carbon production (+25% in installed capacities or an estimate of 100 MW compared with BAU in 2020).

Transportation would provide 12% (or 96Mt) of global emission reductions. These results rely on some improvements in energy intensity (toe/Mpkm) but more on improvements in carbon intensity (tCO_2/toe, by 3% compared with BAU). If energy efficiency efforts on transport fleets are a significant lever of reduction, modal shifts also occur.

The residential sector also contributes substantially, by 10% (60 Mt) to the global emission reduction volume.



source : Iddri, from PRIMES data & adaptation of POLES- Enerdata figures

By 2030, the considered scenario reaches an overall domestic reduction of 20%. The power sector would still contribute the most to emission reductions (50%), followed by the residential sector (14%). Transport, while increasing absolute efforts, maintains is relative share of 7% in global emission reductions.

A illustrated above, a theoretical "Factor 4" unilateral trajectory by 2050 would imply a radical shift in trajectory in 2020 and would require steeper efforts from sectors in the period 2020-2030. Whereas the dialectic is not to realise the entire objective on the European territory, this observation questions the timeframe to transform the EU economy and its achievement on the longer term. There is therefore a lot at stake following a global deal in Copenhagen, when the EU would possibly decide to move to a 30% goal by 2020.

The impacts of moving to a 30% emission reduction target would depend on the way to share the additional reduction goal between the use of offsets and domestic reductions. Once the additional domestic effort to be done is defined, it would depend on the way to share the efforts between sectors under cap-and-trade and non ETS sectors.

The Commission often considers that a 30% emission reduction goal would be equivalent to a unilateral 20% emission reduction objective by 2020. In comparison with the previous scenario, a unilateral 20% emission reduction by 2020 would achieve an additional 260 Mt of emission reduction, leading to increased efforts in the power sector (150 Mt), in the transport sector (40 Mt) and for the residential sector (40Mt) , depending on the potential for energy efficiency improvements in all sectors. This would more or less correspond to the theoretical Factor 4 trajectory by 2020, whereas efforts required afterwards are even more significant.

The EU will have to adopt more policies and measures to scale up emission reductions to the required level if a satisfactory agreement can be reached in Copenhagen. The amended EU ETS Directive and the Effort Sharing Decision contains an adjustment clause (art. 28 ETS Directive, art. 8 of non ETS Decision) which provides that 3 months (at the latest) after the EU signing an international agreement on climate change, the Commission shall submit a report assessing the nature of the agreed measures and commitments as well as its implications for EU climate policy.

Following this, the Commission could announce a Climate and Energy Package II with the view for the EU to adopting additional policies and measures, in particular for further improving energy efficiency in the residential sector as well as in the transport sector.

The Commission should also come up with proposals to reduce emissions from agriculture in the context of the "Health Check" of the common agricultural policy (CAP). Even though agricultural emissions in the 27 EU countries fell by 20 % between 1990 and 2006 as a result of the significant decline in livestock numbers and more efficient application of fertilisers and better manure management, they still account for about 9 % of total EU greenhouse gas emissions.

The role of economic recovery plans

"The global economic recovery presents an ideal opportunity for countries to shift towards low-carbon growth. Countries which don't seize this opportunity will undermine their future competitiveness and prosperity" (Lord Nicholas Stern, in preface to the G20 Low-Carbon Competitiveness report). One can only welcome the growing global consensus on this issue. At the G20 Summit in April 2009, heads of states and governments pledged to "make the transition towards clean, innovative, resource efficient, low-carbon technologies and infrastructure". At the meeting of the Major Economies Forum on Energy and Climate that took place in July 2009, it was recognised that tackling climate change will require "ambitious policy reform in all the major economies to drive growth and job creation in the low-carbon industries of the future".

The fight against climate change can therefore be combined with major new economic opportunities to develop new technologies and create "green jobs" and enhance energy security. That is now a position firmly taken by the European Commission,[3] backed by the European Parliament and the Council of Ministers who reached an agreement in May 2009 on a European Energy Program for Recovery with a budget of €3.98 billion to be allocated to energy projects in gas and electricity infrastructure (€2,365 million), offshore wind energy (€565 million) in the North and Baltic Seas into the onshore grid, and carbon capture and storage (€1,050 million). Unspent funds may be used for energy efficiency and renewable energy projects. The Recovery Plan will provide up to half the costs of gas and electricity infrastructure and offshore wind energy projects. Carbon capture and storage (CCS) installations can be co-financed with up to 80% of the costs.

It is important that the Recovery Plan allocates these resources in projects that contribute to structural changes, in particular for making the use of gas and electricity cleaner and more efficient.

An ambitious agreement at Copenhagen could accelerate the transition to a low carbon economy: mid term targets and long term global emissions reductions goals involve a complete shift in overall carbon productivity and investments in clean technologies. From that perspective, it is of utmost importance that climate change mitigation and adaptation measures are fully combined with economic recovery measures and, more generally, integrated into all EU policies.

In his political guidelines for the next Commission (September 2009), President Barroso suggested that *"each and every Community policy will need to be assessed and if necessary adapted in the light of climate change"*. One can only support this approach as it is consistent with Article 6 of EC Treaty which sets forth the integration principle into EC law. This principle provides that environmental protection requirements must be integrated into the definition and implementation of the Community policies and activities referred to in Article 3, in particular with a view to promoting sustainable development. According to it, *all* policies of the EC are covered. The integration principle is to be regarded as a means of coordination between these policies. Like the extended impact assessments conducted for major policy reforms since 2002, carbon impact assessments could systematically be carried out in the future to determine the right policy choices by reference to mid term and/or long term emission reduction targets. Such carbon impact assessments would be even more justified when the Lisbon Treaty enters into force in so far as it will introduce a legal basis for climate action in Article 174 of the EC Treaty as well as a legal basis for an EU energy policy.

Closing the climate gap

In spite of its contradictions, the EU climate programme remains advanced compared to the US or Japan for instance. EU climate action can sometimes be quite daring: aircraft emissions were handled with remarkable determination with the EU bypassing the International Civil Aviation Organization under the UNFCCC to apply emissions trading unilaterally to both EU and foreign aircrafts. On the other hand, the focus on "carbon leakage" throughout the negotiation of the Climate and Energy Package led to major deviations conveying the idea that protecting European industry was a bigger priority than creating an efficient incentive framework to transform the domestic economy and assume actual technological, economical and political leadership in global climate action. This raised questions about the EU's commitment to the international negotiation process and its outcome.

EU policy is indeed the product of compromises among 27 States characterised by different income levels, economic structures and energy mixes. While the transition to a low carbon economy and the cost of climate change after 2050 is on the European Commission's agenda, member states' remain concerned about the short-term preservation of existing business and jobs for voters.

One may also stress the weight of strategic energy security concerns. While switching from coal to natural gas is a typical example of abatement, the risk of depending on imported gas in a difficult political context secures coal's role as a pillar of electricity production in the EU. It is for similar reasons that peripheral member states that are poorly connected to the EU grid were granted derogations to avoid alleged "carbon leakage" resulting from importing non EU electricity, i.e. increased dependency on third country energy.

Going to the negotiation table with a pre-established climate policy "package" to establish ones leadership has not proved to be an efficient strategy yet. Interestingly, the new US administration seems to replicate that strategy with similar measures (Waxman Bill) but under weaker emissions reduction targets on the short term and still with no back up from the Congress. Unless major bargaining power is found, with its leadership in question, it is doubtful that the EU plan can prevail over a less ambitious US strategy that will be easier for other key players, in particular Japan and Canada, to sideline with. In addition there is a possibility for the US to simply pull out of climate talks, a kind of leverage the EU does not have. This increases chances that a "shared vision" will emerge from a combination of lowest common denominator and power play rather than lukewarm EU support to IPCC consensus on the 450ppm target.

To maintain its environmental ambition for a post-Kyoto climate regime the EU may have to accept any conditions put forward by international partners in terms of financing, emission credits, offsetting and monitoring methodologies or burden sharing. This last option would likely imply reducing EU emissions further to compensate weaker commitments by third countries and mitigation costs even higher than those expected under a 30% reduction target. If third countries required further efforts, it would be difficult for EU negotiators to react without taking the risk of being disapproved by member states in the follow-up process.

On the other hand, giving up on the 450ppm target questions the principle of climate change mitigation if coordinated action in the short term does not contain the risk of passing “tipping points” with unmanageable and irreversible climate events, tragic human consequences and prohibitive costs.

One way to keep the EU united on the climate international front could be to have a single but ambitious EU target in the Copenhagen Agreement, to be distributed internally thereafter through EU implementing measures. This could raise further the level of centralisation of EU climate policy, certainly more than in other policy areas of shared competence between the Community and its member states. It would empower the Commission to propose additional implementing measures while taking account of the need for efficiency, equity and solidarity within the EU.

Finally, we propose some suggestions to close the gap. EU climate and energy policy is working to reinforce energy security and diversity of supply, while providing additional finance to provide for more sustainable use of imported energy. An important part of the EU’s foreign policy in the future will focus on its relations with its energy suppliers. If domestic energy is not made more competitive, in the next 20 to 30 years around 70 % of the Union’s energy requirements will need to be met by imported products – partly from regions threatened by insecurity.

In order to prevent conflicts that could be induced by climate change, the EU’s foreign policy should push for deeper involvement of the UN Security Council in environmental security. In any case, an in-depth reflection on the role and tasks of the Security Council cannot be avoided. Security should be envisioned as a whole, encompassing human security, and should not be limited to international security. The adaptive capacities of weak and fragile states should be reinforced through cooperation, especially if they play a pivotal role in these regions.

Disaster reduction will play an important role in mitigating the impacts of climate change. Disaster reduction policies should be mainstreamed into climate policies, and the EU could play an important role in fostering international cooperation in this area. In particular, the role of the European Commission on Humanitarian Aid within the International Strategy for Disaster Reduction (ISDR) could be further reinforced.

With regard to cooperation and development aid, climate policies should be further mainstreamed into EU cooperation and development policies.

Development aid should foster adaptation strategies, and needs to be increased in order to avoid the threats of climate change to ongoing development processes. Adaptation and development aid should go hand-in-hand, and not on different paths. Partnerships could also be developed in technology cooperation – such partnerships are vital for the success of a global agreement on climate.

The EU also bears a responsibility for the migration flows that will be triggered by climate change. Such population displacements will be mostly internal movements, but could potentially destabilise fragile regions. The EU should push for an international recognition of these migrants and for further support aimed at the countries affected by such population displacements. EU's asylum and immigration policies will also need to account for these migration flows: in that regard, people displaced by climate-related events could benefit from a special protection status within the EU, and resettlement policies should be further developed in order to alleviate the burden from countries affected by these displacements.

Finally, in the field of industrial policy, the goal must be for the EU to maintain its lead in key technologies for the future, both for competitiveness reasons and because ensuring that advanced technologies such as CCS get to the market is imperative to decarbonise the global economy and meet the 2°C target.

To sum up, while the EU has played a leading role in the field of climate change, the path ahead is not as simple as it may appear. Much still remains to be done, and the measures outlined above would be an initial step.

End notes/references

Chapter 2

1 Re-named in the draft Lisbon Treaty as 'Common'= CDSP.

1 A phrase in the Lisbon Treaty about mutual defence in case of military attack is self-negated by provisions protecting the primacy of NATO and the national policies of the six non-Allied member states, respectively.

3 URL: http://www.consilium.europa.eu/cms3_fo/showPage.ASP?id=266&lang=EN&mode=g. The Council approved in Dec. 2008 a report on the updating of the ESS but this did not significantly alter the features discussed here.

4 This and other public opinion references are from 'Transatlantic Trends' 2008, key findings at: http://www.transatlantictrends.org/trends/index.cfm?id=123.

5 For facts on ESDP see the Council webpage http://consilium.europa.eu/cms3_fo/showPage.asp?id=261&lang=EN&mode=g.

6 See the article by A.J.K: Bailes and J Haaland Matláry in International Affairs, Vol 84 No1, January 2008

7 Notably B. Giegerich and A. Nicoll, 'European Military Capabilities - Building Armed Forces for Modern Operations', IISS London 2008.

8 Eg N. Witney, 'Re-energising Europe's Security and Defence Policy', European Council on Foreign Relations July 2008, text at http://ecfr.eu/page/-/documents/ESDP-report.pdf. A different take on PSC is S. Biscop, URL http://www.egmontinstitute.be/papers/08/sec-gov/080918-Biscop-Helsinki-paper.pdf.

9 This makes more sense than forcing every country to spend e.g. 2% of GDP because so much national defence spending is simply wasted.

Chapter 3

1 The most notable milestone was the agreement in December 2003 by the European Council of the European Security Strategy. Other key documents of the 'new orthodoxy' are the Long-Term Vision agreed by EU Defence Ministers in October 2006, and the Strategy for the European Defence Technological and Industrial Base of May 2007 – both on the European Defence Agency website.

2 http://www.consilium.europa.eu/showPage.aspx?id=1268&lang=en

3 "A Strategy for the European Defence Technological and Industrial Base" -- http://www.eda.europa.eu/documents.aspx

4 Average for the three years 2005 to 2007, based on data presented in the IISS 2008 strategic dossier on European Military Capabilities.

5 2 April 2009: http://www.ft.com/cms/s/0/6e8b7840-1fb2-11de-a1df-00144feabdc0.html

6 http://www.securityconference.de/konferenzen/rede.php?menu_2009=&menu_konferenzen=&sprache=en&id=237&

7 http://www.telegraph.co.uk/news/worldnews/northamerica/usa/barackobama/5101682/Barack-Obama-says-Europe-should-not-look-to-US-as-defence-patron.html

8 It was encouraging to note that the subject was on the agenda of the Franco-British summit at Evian in July.

9 Ditchley Foundation Lecture, 11 July 2009 -- http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/discours/109193.pdf

10 A 2008 ECFR Report by the present author on "Re-energising Europe's Security and Defence Policy" -- http://www.ecfr.eu/content/entry/european_security_and_defence_policy -- set out much of the agenda – and similar prescriptions emerged from an unexpected quarter when the ippr Commission on [British] National Security, co-chaired by the Lords Ashdown and Robertson, recently concluded that "European cooperation is the only way forward" -- http://www.ippr.org.uk/publicationsandreports/publication.asp?id=676 .

Chapter 4

1 Babacan at the Boshporus conference, October 2007.

2 The study can be read on: http://www.bertelsmann-stiftung.de/bst/en/media/xcms_bst_dms_18555_18556_2.pdf

3 Helen Wallace, "Adapting to Enlargement of the European Union: institutional practice since 2004", Trans European Policy Studies Association, November 2007.

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Chapter 6

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Chapter 7

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Chapter 9

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2 *If overall costs are reduced at their maximum, see for instance the Commission Communication of October 2009 (COM (2009)518/4) on Investing in the Development of low carbon technologies (SET-PLAN). But so far, demonstration costs delay the prospects for such a price range reducing the adequacy of the ETS market to foster such a technology on the short term*

3 *(see Communication of 26 November 2008: "A European Economic Recovery Plan" (COM (2008) 800 final))*

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