The Future of the European Union

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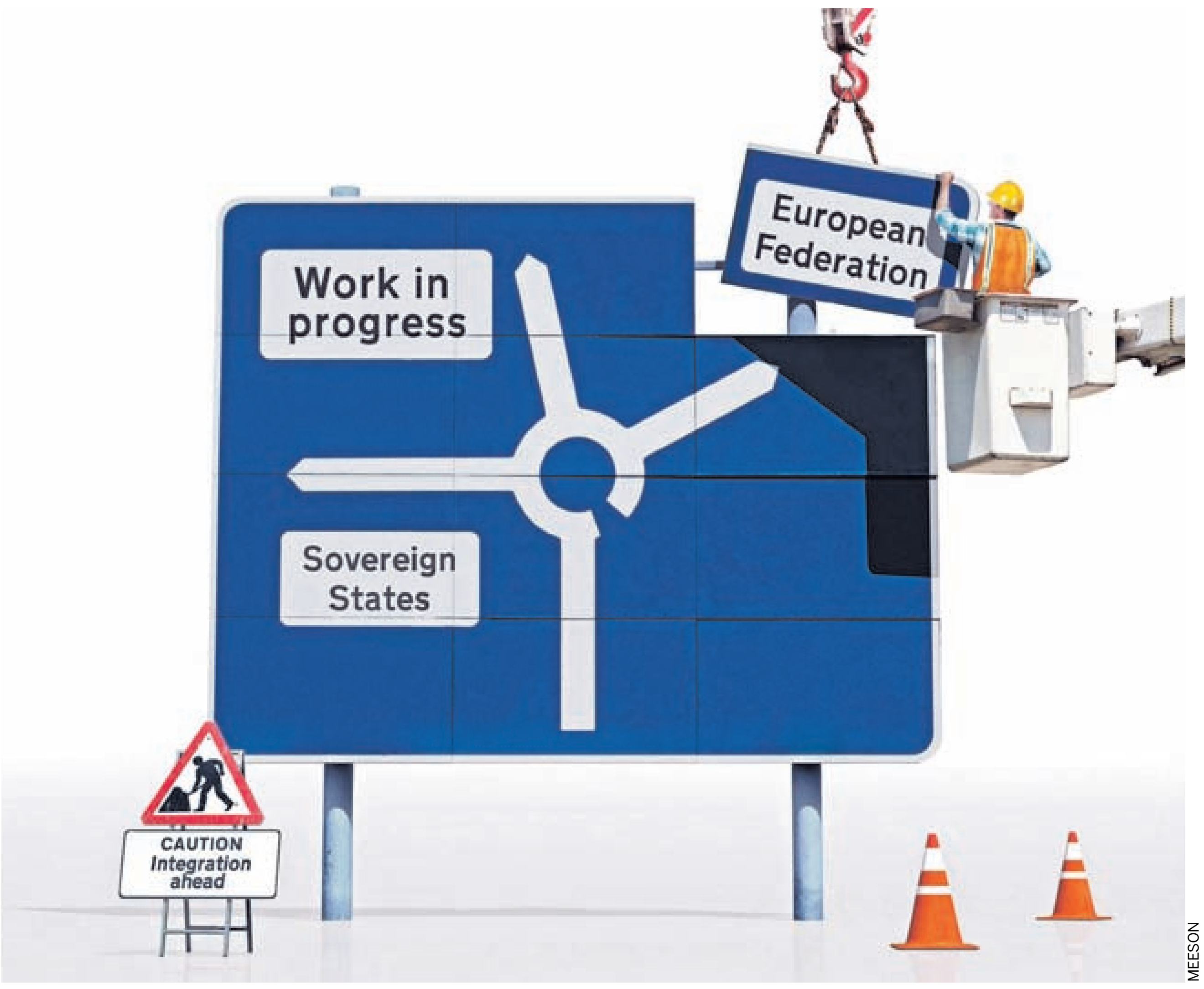
EU seeks road to redemption

While Europe appears determined to master its destiny, long-term solutions are hard to find, writes *Tony Barber*



MEESON

Three years after Greece's financial emergency rattled the foundations of Europe's monetary union, political and economic shocks continue to jolt the European Union in countries as diverse as Cyprus, Hungary, Portugal and Slovenia.

The introduction of stringent capital controls in Cyprus, as part of a €10bn, European-led rescue of the island's economy and financial system, gives the lie to the notion that threats to the 17-nation eurozone's unity are receding. Yet, in certain respects, the area's sovereign debt and banking crises appear less acute today than 12 months ago, thanks in part to the European Central Bank's promise of unlimited intervention to protect vulnerable member states.

In other policy areas, such as the long-term effort to stabilise its Balkan neighbours, the EU is notching up important successes. Croatia will join the bloc in July as its 28th member, and the EU has brokered a settlement between Serbia and Kosovo, wartime foes as recently as 1998-99, that should bring both closer to membership.

None of this can disguise the importance of overcoming Europe's economic difficulties. Europe's growth prospects, scarcely robust even in the pre-crisis era, will be subdued for the foreseeable future. Some countries are in prolonged recession and suffering mass unemployment. The eurozone's unity suffers from stark and persistent differences in financing conditions for creditor and debtor countries.

Moreover, political populism is becoming an established feature of public life in many EU countries. Populist movements see next year's European parliament elections as an opportunity to seize votes from traditional parties judged by many voters to be incapable of restoring jobs, growth and a robust welfare state. The longer the crisis continues, the more it chips away at flagship initiatives such as the EU's carbon emissions trading scheme, once intended as a beacon to the world for fighting climate change.

Inside the eurozone, fundamental disagreements divide Germany and its allies – which assert that fiscal austerity and structural economic reforms will one day produce positive results – from other countries. The latter maintain that present policy is self-defeating and alienating the public.

"Pursuing a strategy that deepens recession and weakens confidence will not resolve the debt crisis," Yannos Papantoniou, who served as Greece's finance minister from 1994 to 2001, wrote in April for Project Syndicate, an online commentary forum.

More broadly, the question of how far the EU wishes, or is able, to go down the road of deeper integration in a bid to find a long-term solution to its troubles remains without an answer. Difficult economic, political, legal and social conditions in the biggest member states – France, Germany, Italy, Spain and the UK – supply much of the explanation for this indecisiveness.

In political terms, Germany's federal election on September 22 will be crucial in giving impetus to the EU's efforts at crisis management. A broad consensus unites the centre-right coalition of Angela Merkel, chancellor, and her Social Democrat and Green opponents on Germany's responsibility, as the area's pre-eminent economic power, to defend the eurozone. Most mainstream politicians share Ms Merkel's view that a break-up of monetary union would shatter the wider process of European integration that has delivered peace and prosperity for more than half a century.

However, the election campaign is putting on hold much-needed German decisions on closer integration, particularly a European banking union. A burning issue for Germany's partners is whether the next government will stick to the position outlined in April by Wolfgang Schäuble, finance minister, that a banking union will require

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The Future of the European Union

Fate of transatlantic agreement hinges on political pragmatism

Trade

Projected gains from a pact stretch beyond economic growth, says *Joshua Chaffin*

When the EU and the US announced plans in February to embark on negotiations towards a transatlantic trade agreement, enthusiastic politicians branded such a pact a potential "game-changer".

A transatlantic accord to remove trade barriers would be the world's largest. The European Commission, the EU executive body, reckons it would add 0.5 per cent to the EU's annual economic output by 2027 – about €86bn – while creating millions of jobs without a penny of new government spending. The benefits transcend pure economics. Such an agreement has been touted as a way to reinvigorate a transatlantic relationship that has suffered from drift and lack of interest since the end of the cold war. Will an EU-US agreement ultimately measure up to the lofty promises attached to it? That depends largely on the shape and ambition of a final deal, according to analysts and executives.

"The more they are willing to include, the bigger the benefits will be," says Fredrik Erixon, director of the European Centre for International Political Economy, a Brussels think-tank.

At present, the two sides are still walking up to the starting line. In Europe, Karel De Gucht, the trade commissioner, is working with the bloc's 27 member states to finalise a negotiating mandate with the hope of beginning formal negotiations in June. While it is still early days, Mr Erixon sees troubling signs that some member states may be inclined to limit the scope of the talks before the parties have sat down at the bargaining table.

France, in particular, has repeatedly insisted that the "cultural exception" – a regime that protects its television and music industries from foreign competition – be off the table in any agreement. The French and others have also argued that the EU should not make any compromises on its food safety standards.

To Mr Erixon, the risk is that any carve-outs by Brussels may trigger retaliatory ones from Washington. "The problem is that after this burst of optimism, we haven't really seen much signal that [Europe] is willing to do an ambitious deal," he says.

Other analysts are more sanguine – in part because they are convinced that there is simply too much for the EU and US to gain from an ambitious deal. "Everyone is almost positive this will be an economic win," says Peter Chase, vice-president at the US Chamber of Commerce, which has long championed a transatlantic pact.

In economic terms, the most tangible benefit is that an agreement could eliminate tariffs on goods. They are already low, around 4-5 per cent. Yet the commercial flow between the economies is so great – at nearly €2bn per day – that even small reductions in tariffs would yield sizeable gains.

A Bloomberg study estimates that the US chemicals industry would save $1bn a year if tariffs were eliminated. Those savings reflect the unique pattern of transatlantic trade for many large US and European companies, which tend to have operations on both sides of the Atlantic and regularly send goods back-and-forth during their production.

Mr Chase believes a related effort to smooth out customs procedures to make them faster and more efficient will create savings that make European and US companies more competitive against their global peers. "One part of this agreement that no one really talks about is customs facilitation," he says. "It could be huge."

> 'We haven't really seen much sign that [Europe] is willing to do an ambitious deal'

But the biggest prize may be harmonising competing safety and technical standards that create extra costs and headaches for businesses. "In a market as integrated as ours, where tariffs are as low as they are, these are the effective barriers that remain," Mr De Gucht said in March.

Consider the auto industry, where companies are forced to satisfy competing – often conflicting – regulations. "When you look at the technical requirements to build a seatbelt in Europe and the US, it's almost discouraging to see the degree of differences in arriving at a common outcome," says Stephen Biegun, Ford Motor's vice-president of international governmental affairs.

Dismantling such barriers is not as straightforward as raising and lowering tariffs. It requires often painstaking negotiations. These become more fraught when the standards reflect visceral beliefs, such as Europeans' aversion to genetically-modified organisms or hormone-treated beef. As talks progress, Mr Biegun acknowledges the risk that an accumulation of narrow disputes could render a final agreement hollow. "Could it get picked apart to the point where it's no longer interesting? Absolutely," he says. Still, he remains optimistic, based on the recent success of EU and US automakers in setting common industry standards for electric vehicles.

"That was the test case," says Mr Biegun, "that gave people confidence that this could be successful". The fate of the transatlantic trade agreement may depend on whether European and US politicians can demonstrate similar pragmatism.

Hint of southern comfort shows need to bolster reform process

Prospects for those countries hardest hit by the eurozone crisis – and their ability to embrace tough policies – are assessed by *FT writers*

The refrain has been constant throughout the painful course of the eurozone crisis. From the acute case of Greece, through bailed-out Portugal, to recession-hit Italy and Spain and, not least, sclerotic France, the call has been for deep structural reforms to secure permanent recovery of economic health across the EU's southern belt.

The near unanimous prescription is that these countries must accompany the repair of their public finances with a re-engineering of their labour, product and service markets to combat the curse of mass unemployment and regain lost competitiveness that collectively undermines eurozone performance.

As 2013 shapes up to be another year of recessionary pain – or at best, zero growth – for these countries, what is the reform record to date? In particular, what are the prospects for reform in France, the eurozone's second largest economy after Germany that has so far avoided the worst hardships of its southern neighbours but which is now firmly in the spotlight as it struggles to generate growth.

Italy

Mario Monti's technocrat government started strongly with important pension reforms that will help shore up the public finances. But his attempt at labour reforms, aimed at narrowing the gap between workers on permanent and short-term contracts, became a political minefield. Changes were widely criticised as not helping new workers, especially among the country's youth where the jobless rate has risen 3.9 points to 37.8 per cent over the past year.

GDP in 2012 fell 2.4 per cent with a further decline of up to 2 per cent forecast this year. Independent estimates suggest the combined impact of Mr Monti's reform programme will be worth about 0.4 per cent growth a year. Meanwhile, although Italy is posting a trade surplus owing to tumbling imports, exports have fallen recently.

Spain

Scarred by 27 per cent unemployment and an economy set to shrink again this year by 1.4 per cent, Mariano Rajoy's conservative government has pledged to step up the pace of reform. Critics say the government's focus has been too heavily on fiscal consolidation. The European Commission recently criticised the reform programme as "incomplete" and suffering from "implementation lags". Madrid is reviewing its labour market and pension reforms and has promised by the end of this year to liberalise its heavily regulated professions. But Spain is benefiting from improved labour cost-competitiveness. "They have not lost export market share," says Eric Chaney, chief economist at Axa, the insurer. "If credit starts flowing again, Spain could surprise us."

Portugal

The government has made progress in reforming labour legislation, cutting previously generous redundancy payments by more than half and freeing smaller employers from collective bargaining obligations, all components of Portugal's €78bn bailout programme. Unit labour costs have fallen since 2009. Advances have been made in speeding up the court system, liberalising some working practices and streamlining industrial licensing but many reforms remain in the pipeline.

Greece

Liberalisation of labour markets has enabled Greece to close the cost-competitiveness gap with other southern eurozone countries by about 50 per cent over the past two years. Most of this has come from wage cuts but business confidence has jumped. Opening up product and service markets has proved a tougher task as interest groups slow reforms. Privatisation is lagging with revenue targets missed. The biggest challenge is to overhaul the tax administration with less than 10 per cent of annually assessed taxes paid. Poul Thomsen, the IMF official who heads the bailout mission, said recently: "In structural terms, Greece is more than halfway there."

France

The pressure on President François Hollande's socialist government to shake up the flatlining economy is mounting. As Olli Rehn, the EU's economic commissioner, remarked: "France is a core country. Its health has a very direct impact on the overall health of the eurozone." With unemployment above 10 per cent, public debt above 90 per cent of GDP and a yawning trade deficit, Mr Hollande has pledged to overhaul the heavily state-dependent "French model". He has introduced a €20bn tax break for companies to help reduce France's high labour costs and overseen a deal between trade unions and employers to lighten some of the country's heavy labour market regulation.

As part of a programme to reduce public spending – the second highest in Europe at 57 per cent of GDP – reforms of unemployment benefit, the generous family welfare system, the pension regime and costly local government administration are all promised for later this year. But real doubts persist over whether the government is prepared to move far and fast enough. Companies complain that the tax break simply offsets the cost of other tax increases imposed on business. They say the labour reform does not go far enough to tackle deep rigidities that discourage employment, especially of the young.

"While these reforms are in the right direction, they will not be sufficient to solve the competitiveness issues," the European Commission said in a recent report. "Further policy response will be needed."

Reporting by Hugh Carnegy in Paris, Guy Dinmore in Rome, Tobias Buck in Madrid, Peter Wise in Lisbon and Kerin Hope in Athens

Demonstrably upset: Spain's high jobless rate has led to mass protests Getty

Work proceeds on bank rules

Banking union

Sharing risks of the financial sector is back on the agenda, reports *Alex Barker*

European banking union is an integration drive unrivalled since the creation of the single currency, a vision to fuse governance of banks so credit again flows freely to the battered economies of Europe's south.

It has been seriously discussed in Brussels for less than a year and encroaches on fundamental powers that states jealously guard: the right to oversee banks and ultimately decide if and when they should be shut down.

Even in this short time, big strides towards banking union have been made, not least with an agreement in December to make the European Central Bank (ECB) the top supervisor for at least the euro area's 6,000 lenders.

The trouble is that, like all of the boldest European projects, progress comes in fits and starts and the ultimate destination remains contested and liable to change. "We cannot manage the crisis by diktat or impose leaps in integration for which people are not ready," says Jörg Asmussen, an ECB executive board member and an early advocate of banking union.

Overshadowing all the technical negotiation is a broader political dilemma – felt acutely in Berlin – over the fiscal implications of true banking union. When completed, it paves the way for potentially sharing the risks of the financial sector, with German taxpayers, for example, standing behind Spanish banks and guaranteed deposits. "I don't think they even know in Berlin whether this is the ultimate goal . . . whether they are ready to really complete monetary union," says one senior EU official.

Detailed below are the patchy steps towards banking union, the transitional measures in place and the political battles ahead.

Common supervision and rules

This is the legal groundwork for the ECB to become the eurozone's top supervisor. This could begin as soon as next year but, in reality, the transition will take several years, as the ECB hires staff, learns its role and begins to flex its muscles with national authorities. The balance of power with existing supervisors is untested. At the same time, the EU is building a single rulebook for all EU banks. The cornerstone is a bank capital law, passed last month in Brussels, which implements the Basel III capital accord. Talks to harmonise national rules to wind-up banks are progressing, albeit slowly.

Single resolution authority

This is fast becoming the area of greatest friction between member states as the European Commission prepares to publish a proposal in June to create a single authority to wind-up banks, backed by a single fund. The ECB is actively championing the reform, for fear that central supervision would be undermined by national authorities unwilling or unable to close down banks in a timely manner.

Germany, however, is cooling to the idea. Wolfgang Schäuble, the German finance minister, is convinced EU treaties would have to be changed to give a sound legal basis to the reforms. As an alternative, Berlin is promoting the idea of a network of national resolution authorities, which leaves member states responsible for costs.

For its part, the Commission appears determined to press on with an ambitious reform, based on single market laws in the existing treaties. It is likely to include a resolution agency, which would be backed by the legal authority of an EU institution. The authority will have access to money, pooled from national resolution funds.

Deposit guarantees

Plans for a single guarantee scheme are in the deep freeze. German objections forced the hand of the Commission, which drafted and then shelved plans to bring forward a proposal.

The focus now is on agreeing common rules for national deposit insurance schemes and voluntary mutualisation measures in a crisis – a three-year-old Commission proposal that remains in diplomatic stasis. No agreement is in sight.

EU seeks road to redemption

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a revision of the EU's basic treaty. Even if Germany displays more flexibility on this score, there is little evidence that any governing coalition in Berlin – or Germany's constitutional court – would endorse the at least partial eurozone debt mutualisation desired by other countries.

February's general election in Italy produced not only political gridlock but also a widespread rejection of the economic reformism symbolised by Mario Monti, the technocratic prime minister installed with Europe's approval at the height of Italy's debt crisis in November 2011. From the perspective of Germany and its northern European allies, the question is whether the next government will be strong enough to resume the reform course that started under Mr Monti but gradually faded away.

Arguably, the German political classes are even more concerned about the outlook for reform in France, where François Hollande, the Socialist president, has suffered one setback after another in his first year of office. With a larger than expected budget deficit, economic growth nowhere to be seen, unemployment rising and his popularity ratings diving, Mr Hollande is under pressure to reset his economic strategy to satisfy the French public, the Brussels-based European Commission and his German allies.

A French economic recovery would serve Germany's interests by recreating the sense of balance in the Paris-Berlin relationship so crucial to Germany's need not to look like an overbearing European power. But officials in each capital acknowledge that Mr Hollande and Ms Merkel have struggled to establish the personal rapport between president and chancellor that has often underpinned Franco-German relations since the 1960s.

Beyond the eurozone looms the shadow of a possible UK referendum on continued EU membership and the question of how to uphold the integrity of the EU single market as an inner core of eurozone states move towards closer economic policy co-ordination.

The relative calm that settled upon financial markets in the closing months of 2012 owed a great deal to three decisions taken by Europe's politicians and central bankers. One was to end months of uncertainty over Greece's future by making a firm commitment to keeping the nation in the eurozone.

Greece remains mired in an economic slump without precedent since the 1946-49 civil war. But a degree of stability is returning to the public finances, with Yannis Stournaras, finance minister, expecting a primary budget surplus – that is, excluding debt interest payments – for this year.

> Mr Hollande and Ms Merkel have struggled to establish a rapport

The second decision was the announcement by Mario Draghi, the ECB president, that the bank would do "whatever it takes" to ensure the survival of Europe's monetary union.

By laying down a challenge to financial markets that they were unwilling to take up, Mr Draghi brought about lower borrowing costs for vulnerable eurozone countries, especially Italy and Spain. This proved an important factor for stability in Spain, which avoided asking for a comprehensive EU-IMF rescue along Greek, Irish and Portuguese lines, even though its devastated banking sector did receive help.

The third initiative was the decision to press ahead with an ambitious reform of eurozone banking supervision, putting the ECB in charge of the area's largest banks. It appeared, furthermore, that Europe's leaders were ready to use their common rescue funds to recapitalise troubled banks directly, breaking the "death loop" between weak banks and weak sovereigns tottering behind them.

However, Germany and its northern creditor allies now seem in less of a hurry to set up a full-scale banking union, including direct recapitalisation and a common deposit scheme.

The question is whether the German election will clear the way for the bolder action on these fronts that other governments, in and outside the eurozone, see as critical to conquer the crisis.

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Integration put on back burner

Fiscal union Market calm has led to complacency in national capitals, writes *Peter Spiegel*

In the waning days of 2012, the EU's two presidents issued ambitious reports setting out a multi-year timetable for transforming the eurozone from a loosely-co-ordinated group of economies into a far more federal system with centralised fiscal control from Brussels.

Although the blueprints issued by José Manuel Barroso, the European Commission president, and Herman Van Rompuy, his European Council counterpart, differed in their details, both shared a common goal: creating an embryonic eurozone budget that could eventually evolve to a US-style federal treasury with the power to tax, spend and raise debt.

"There are still important challenges to the . . . existence of economic and monetary union," Mr Barroso said when he unveiled his plan. "We must counter this crisis of confidence by showing we are ready to strengthen co-operation and integration."

The two presidents' plans were developed in response to a mandate by the EU's presidents and prime ministers who, in the midst of a Spanish and Italian bond market meltdown earlier in the year, had ordered up the detailed timelines in order to convince financial markets that they were serious about completing economic union.

But just weeks after the plans were unveiled, at the last EU summit of the year, those same leaders essentially gutted them.

A draft of the summit's communiqué distributed to national capitals two weeks before the gathering included a date-specific three-stage process towards a "progressive pooling of economic sovereignty at the European level". But by the time the communiqué was published at the end of the two-day summit, all dates had been removed and Mr Van Rompuy and Mr Barroso were asked to revisit the issue in June. The only reference to a eurozone budget was the suggestion that the two examine "solidarity mechanisms" in the June review.

The failure to act at the summit has reverberated across the eurozone, with those most involved in crisis management concerned that the market calm that has predominated since the end of last year had led to a sense of complacency in national capitals.

"Even if there is less reason for pessimism at the start of 2013, we cannot afford to lower our guard," Olli Rehn, the EU's economic chief, said just weeks after the summit.

There remain few signs of willingness to make further moves towards economic and fiscal union, once the core of the bloc's crisis response.

Officials and analysts say the decision by the European Central Bank to "do whatever it takes" to save the euro has so damped market concern that national leaders no longer have an incentive to pick up the politically combustible issues of economic and fiscal integration.

They also warn that given the recent uncertainty that Cyprus and Italy have introduced, national leaders would be mistaken to rely on the ECB's largesse alone.

"The ECB's evolution to lender of last resort has significantly blunted market pressure and with it the political momentum behind deeper eurozone integration," says Mujtaba Rahman, Europe analyst at Eurasia Group risk consultancy.

Defenders of the EU's efforts argue that compared with the start of the crisis, the amount of fiscal integration within the eurozone has increased substantially. The first big post-crisis reform, this gave Brussels the authority to fine countries that fail to hit tough EU-mandated deficit targets, has become a powerful tool to force budget discipline and is driving austerity policies.

In addition, this month new EU rules will be put in place that will force eurozone countries to submit their national budgets to Brussels every year for evaluation and allow the commission unilaterally to send monitoring missions to national capitals if they feel the government is not living up to its reform commitments.

Since those rules were first proposed in November 2011, no major initiative towards fiscal union has been tabled, with leaders concentrating on "banking union" – partly because they believe focusing on the financial sector may be less politically sensitive than the tax and spending policies at the core of national sovereignty.

Mr Barroso has vowed to push for a more federal eurozone budget and in March published an outline for a so-called "convergence and competitiveness instrument" that would give countries access to a nascent eurozone budget in times of crisis if they agreed to clear benchmarks for economic reform.

Member states' response has been tepid and some economists worry that without more rapid movement, integration could reverse, causing further economic uncertainty.

"It is too slow," says Karl Aiginger, an Austrian economist doing research on Europe's economic governance. "We will have two more years of sluggish growth in Europe as a whole and no growth in the south. Governments will collapse."

Scuppered: José Manuel Barroso and Herman Van Rompuy's detailed plans for a new eurozone budget were gutted by members Getty

'The ECB's evolution to lender of last resort has blunted market pressure and political momentum'

Financial crisis fuels talk of democratic deficit

Political reform

Legitimacy problem rears head as citizens question authority, says *Joshua Chaffin*

Last year, when Belgium was faced with demands from the European Commission to shave a further €1bn-€2bn from its budget, a furious Paul Magnette, the Belgian energy minister, gave voice to European frustration.

"Who knows who Olli Rehn is?" Mr Magnette asked, referring to the EU economics commissioner.

The most visible casualties of the financial crisis that has plagued Europe for the past five years have been public finances and employment. But there are signs that it is also inflicting a more subtle but corrosive form of damage by eroding the EU's claim to democratic legitimacy.

Even in good times, the EU has struggled with criticism that it is an opaque bureaucracy cut off from the citizens it was intended to serve. A steady decline in voter turnout over the past three decades for European elections has lent credence to the idea that citizens feel increasingly estranged from the European project.

The crisis appears to be making this worse by prompting politicians to rush through policies that concentrate more power in Brussels with limited public understanding or support.

The multibillion-euro bailouts that have imposed deeply unpopular austerity policies across the eurozone's periphery have generally been hammered out behind closed doors under urgent pressure of markets.

The crisis has spawned potentially far-reaching fiscal rules that give unelected technocrats in Brussels the authority to scrutinise national budgets and economic policies.

As Mr Magnette made clear, few politicians – let alone citizens – seemed to be aware of the rules even as the latter encroached on their sovereignty.

"There is a deep problem now of trust of the normal European citizen toward the European Union," José Manuel Barroso, the European Commission president, acknowledged recently, warning about a growing sense of "Europe fatigue".

That has been borne out by the rise of populist politicians in Greece and Italy. Opinion polls analysed by the European Council on Foreign Relations think-tank reveal discouraging trends in both the wealthy eurozone countries that have underwritten bailouts and the poorer ones that have received them. The percentage of Germans who distrust the EU jumped from 36 per cent to 59 per cent from 2007-12, according to the ECFR. In Spain, the number soared from 23 per cent to 72 per cent.

"There is a legitimacy problem," says Andrew Duff, a British Liberal Democrat MEP, who has long focused on the issue. "We've got to simplify the system of governance so that people can understand what's going on and who's in charge."

The EU's "democratic deficit" is an enduring subject of debate in Brussels.

Analysts such as Larry Siedentop, a political philosopher at Oxford, warned in his 2000 book *Democracy in Europe* that EU integration was moving too quickly for citizens and focused on their wallets instead of their political hearts.

There has been much discussion on strengthening the role of the European parliament, the only directly-elected part of the EU apparatus. Its powers have grown greatly since the 2009 Lisbon treaty, which has given MEPs a say over nearly all EU legislation. Yet, even some MEPs complain that the parliament is too obsessed with power struggles against rival EU institutions to connect with the public beyond Brussels.

In a bid to avoid another decline in voter turnout in next year's elections, Mr Barroso has suggested the different political groups identify a possible candidate for commission president. The idea would be to give citizens a more visible sense of what is at stake.

Mr Duff supports that but he believes the real source of the EU's democratic deficit is not the parliament but the commission that it is supposed to oversee. The EU's executive arm, he argues, has become trapped in a middle ground where it has gained just enough authority to worry citizens without the resources to deliver the benefits they desire. He says the commission should be a proper government with a treasury and ability to raise revenue.

Doing so would require another change to the EU treaties – an arduous and potentially divisive process. In any case, it is hard to imagine citizens giving even more power to Brussels as the cure for an EU that many increasingly view as the problem.

Additional reporting by Joseph Bambridge

'There is a deep problem now of trust of the normal European citizen toward the EU'

Struggle for coherence remains intense in diplomatic relations

Foreign policy

Economic travails are undermining the bloc's influence, reports *James Blitz*

Western diplomats have long complained that the European Union has a foreign policy that is fragmented and incoherent, one that will never reconcile the rival diplomatic ambitions of its 27 member states.

But every now and then, there is a moment when the gloom should be set to one side. Such a moment came on April 19 when Catherine Ashton, the EU's foreign policy supremo, sealed an initial peace agreement between Serbia and Kosovo.

For years, the crisis between Serbia and Kosovo had seemed so intractable that the EU's 27 states were happy to leave it to Baroness Ashton to try and solve.

Last month, she surprised the sceptics, persuading the prime ministers of both states to initial an agreement that will break the constitutional logjam that has dominated the western Balkans for years.

"It was an undoubted success," says Ian Bond of the Centre for European Reform (CER), a London-based think-tank. "It shows that forging a relationship with the EU still has a lot of attractions for its neighbours. Catherine Ashton's patient approach certainly paid off."

That said, praise can only go so far. If the Serbia-Kosovo agreement is remarkable, it is because the EU has had so few foreign policy successes in recent times.

On diplomacy over Iran, Baroness Ashton has certainly won plaudits. She has chaired the six powers that negotiate with Tehran over its nuclear programme very effectively. She has ensured that the US and Russia maintain a common front in trying to get the Iranian regime to scale back its nuclear ambitions

In relations with Russia, EU member states have also shown more coherence over the past year than was the case. As the European Council on Foreign Relations (ECFR) said earlier this year in its "scorecard" on the bloc's foreign policy, in 2012 "the EU was more attentive to protecting its interests and norms, and more assertive than was the case in the past".

That said, there are many areas where EU member states act alone and the struggle for coherence remains intense.

In Mali, France took military action in January to reverse the southward advance of jihadist rebels towards Bamako, the capital. But it then looked to allies for logistical and diplomatic support and found some of them irritated by its decision to act alone.

On Syria, the UK and France are pressing for an abandonment of the EU arms embargo, in order to supply weapons to moderates fighting Bashar al-Assad's regime. However, Germany's Angela Merkel has expressed alarm at the idea while Finland, Sweden, Denmark, Austria and the Czech Republic have all been vehemently opposed.

On China, EU unity has continued to be in short supply, undermining European influence. Beijing, for example, is able to exploit EU disunity to punish prime minister David Cameron for meeting the Dalai Lama, Tibet's spiritual leader, in May 2012, something it vehemently objects to.

"France and Germany get lavish red carpet treatment and invitations to boost trade while the UK has been left in the deep freeze," says one western diplomat. "It would be better if the EU had a more strategic approach."

Underlying these difficulties are three longer-term problems that are unlikely to get resolved soon.

First, the EU remains primarily focused on its internal economic problems. "This is a continent wracked by its euro crisis," says the ECFR's Nick Witney. "There is therefore less bandwidth for thinking about the rest of the world, while the rest of the world is less impressed by the Europeans because of their sluggish economy."

Second, defence spending in all 27 states continues to be cut. In the US, this has brought much dismay. France and Britain collaborate on operations and resources to try and make up for reduced defence expenditure. But in 2012, military spending among Asian nations, in particular China, exceeded that of the Europeans for the first time.

Third, the EU machine faces institutional problems. The European External Action Service (EEAS), the single foreign ministry for the EU, is growing but as the ECFR said in its recent scorecard: "The EEAS is structurally slowed down by the fundamental imperative of co-ordination between the 27 member states, which imposes a heavy constraint on its agility."

Mr Bond of the CER sees the problem in broader terms. "The EU has a lot of instruments – the EEAS, trade policy, the aid budget, the civilian crisis management side – but it has not worked out how to get them playing in a harmonious way."

Ultimately, it is Europe's economic travails that remain the fundamental problem for the bloc as it tries to raise its game in global diplomacy.

The eurozone may be calmer than it was last year, but many external observers still do not believe it has overcome the crisis. As a result, the EU continues to see a significant reduction in its influence and soft power.

Balkan success: Catherine Ashton, foreign policy chief Getty

The EU continues to see a significant reduction in its influence and soft power

Cameron takes a defensive stance

UK role

After a sceptical and widely criticised speech, the British prime minister has his work cut out to restore goodwill in Brussels, reports *George Parker*

Long view: David Cameron, UK prime minister, and Angela Merkel, German chancellor Getty

David Cameron's long-awaited speech on Europe on January 23 was seen by many as the start of Britain's long goodbye to the EU, at a stroke changing London's relationship with the rest of the club.

The in-out referendum in 2017 promised by Mr Cameron, prime minister, was criticised by the Labour opposition as a move that could see Britain "sleepwalking" out of the EU and that would immediately diminish the UK's influence.

That view was shared by Herman Van Rompuy, EU president, who said on a visit to London in February that in even opening the debate so far in advance, the UK had restricted which countries would work with it in the union. "How can you possibly convince a room full of people, when you keep your hand on the door handle? How to encourage a friend to change, if your eyes are searching for your coat?" he asked.

Reports of Britain's imminent exit may turn out to be premature. For a start Mr Cameron's Conservative party would have to win an outright majority at the 2015 general election to deliver the referendum (a feat not achieved since 1992).

The pro-European Liberal Democrats, the minority party in Mr Cameron's coalition government, have made it clear they will not facilitate such a poll whatever the outcome of the next election.

Ed Miliband, leader of the Labour opposition, appears to share the view of Lord Mandelson – former EU trade commissioner – that it would be "clinically insane" for a Labour government to offer an in-out referendum.

"The last thing an incoming Labour government would want – with such a daunting economic agenda facing it – would be to spend two years or more arguing about Britain's EU membership," Lord Mandelson told a Financial Times-sponsored conference.

Even if Mr Cameron was able to deliver his referendum, he has promised to campaign for Britain to stay in the EU – albeit on the big proviso that he is able to secure improved terms of membership. Those terms may not be forthcoming though opinion polls suggest that Britons may still vote for the certainty of remaining in the EU. Polls conducted at the time of Mr Cameron's speech showed a vote would be finely poised.

So, if Britain's departure from the EU is not imminent, how do relations between the UK and the rest of the club – understandably wary of Mr Cameron's intentions – develop over the next few years?

Mr Cameron's first priority is defensive: to prevent an increasingly integrated eurozone core developing rules that undercut the position of those countries outside the EU.

George Osborne, chancellor of the exchequer, has tried to secure by diplomatic means his objectives – for instance, an acceptable voting arrangement on the new European Banking Authority to protect the interests of the City of London.

Should that fail, Britain, he has made clear, will go to the courts. In April Britain launched legal action against Brussels to block an EU levy on financial transactions, which would have affected the City, even though the UK will not participate in the new tax.

Mr Cameron recognises it is not in Britain's economic interest for him to be cast as a constant naysayer, standing on the margins opposing new initiatives while counting down the time to his referendum.

Last month Mr Cameron and Angela Merkel, German chancellor, cemented a strong personal relationship with an agreement at her Schloss Meseberg retreat to push for a more competitive and flexible EU.

Mr Cameron and Ms Merkel – locked into a "marriage of convenience" according to an internal French socialist party paper – are also behind the push for a comprehensive EU-US trade deal.

Britain's Foreign Office is looking at a suggestion by the Open Europe think-tank that an "avant-garde" of liberal countries might be formed to push forward the European single market. Mats Persson, Open Europe's director, says a fully liberalised market could boost growth by €300bn and that "EU leaders can no longer afford to let the slowest member set the pace".

The idea would be to challenge the next European Commission – formed in 2014 – to propose radical reforms. If "protectionist" countries, including France, resisted, then Britain could suggest pushing ahead anyway under the so-called "enhanced co-operation" mechanism.

Such an initiative might be met with scepticism. Mr Cameron's decision to yield to eurosceptic pressure by offering a referendum has lost him valuable goodwill which could take years to recover.

France is not alone in telling the British prime minister that Europe is not just about the single market.

As French foreign minister Laurent Fabius said: "You can't do Europe à la carte.

"I'll take an example which our British friends will understand. Let's imagine Europe is a football club and you join but once you're in it you can't say, 'Let's play rugby.'"

Merkel has more Europe in mind

German elections

Any hopes that a future coalition will dilute austerity plans seem unfounded, writes *Quentin Peel*

The turning point in Germany's strategic thinking towards the EU came in the mid-summer of 2011, according to the best-informed analysts in Berlin.

That was when Angela Merkel, the German chancellor, became convinced that short-term "sticking plaster" solutions to the eurozone crisis were no longer adequate to stabilise the euro and that a more fundamental approach must be adopted.

Yet 18 months on from the party conference in Leipzig when Ms Merkel's ruling Christian Democratic Union called for big new steps towards "fiscal union" and "political union" to underpin the common currency, the debate in Germany has gone quiet.

The country is in the midst of an election campaign to choose a new government in September and yet the future of Europe and the eurozone is the elephant in the room: everyone knows it is the most important issue facing the next German government but no one is making it a big bone of contention.

One reason is that all the main political parties are broadly agreed that "more Europe" is the right way forward. But none of them is sure how to get there.

The other reason is that the opposition Social Democratic party (SPD), and their allies in the Green party, are conscious that the eurozone crisis plays well for Ms Merkel in the election campaign.

"The chancellor has positioned herself in such a way that people are reassured Germany won't throw good money after bad," says Michael Roth, SPD European affairs spokesman in the Bundestag. "Europe is too important [for us] to commit the danger of populism. [So] the SPD has pursued a constructive policy, with a very difficult debate inside the party."

Angelica Schwall-Düren, Europe minister for the state of North Rhine-Westphalia, and another leading SPD official on EU affairs, says: "Europe will certainly be a theme, but not a central theme of the debate between . . . the two candidates [for chancellor]."

That may change, with the launch of a new eurosceptic party – the Alternative for Germany (AfD) – challenging the political consensus in support of the euro. "We are not anti-Europe but we are anti-euro," says Bernd Lucke, who is leader of the new party.

No eurosceptic party has ever gained more than the 5 per cent minimum needed for seats in the German Bundestag, or any state legislature, but if the AfD were to win just 3 per cent support, it might upset Germany's finely balanced election arithmetic.

Ms Merkel's CDU, and her liberal allies in the Free Democratic party, are vulnerable to a marginal loss of support.

This has not stopped the chancellor banging her pro-integration drum.

"We need more Europe," she declared at the annual conference of savings banks in Dresden in April. "We cannot have a common currency where everyone pursues different principles."

She wants to see the 17 eurozone members, plus as many of the non-euro EU members as possible, agree on much closer economic and fiscal policy to complement monetary union along the lines proposed by Herman Van Rompuy, European Council president. A banking union is the next step. Closer political union is the end game.

Ms Merkel stops short of any measures that might involve the "mutualisation" of debt in the eurozone and mean German taxpayers bailing out bankrupt banks in other eurozone countries.

"The chancellor has killed the subject of eurozone bonds," says Mr Roth. "If you raise the subject [during the campaign], you can be destroyed politically."

It means that, while Peer Steinbrück, SPD candidate for chancellor, and Sigmar Gabriel, party chairman, have floated the idea in the past of eurozone bonds, or a common eurozone debt redemption fund, as part of the integration process, they have gone very quiet on the subject now.

The government in Berlin is also divided on the need for full-scale EU treaty change to reinforce the integration process. Both Wolfgang Schäuble, Ms Merkel's finance minister, and Guido Westerwelle, foreign minister and former FDP leader, have said they think treaty change is essential. But the chancellor now suggests that only minor amendments may be necessary "for the time being".

> 'We cannot have a common currency where everyone pursues different principles'

In that, she seems to be conscious of what her EU partners can accept – especially France. Ms Merkel is acutely aware that François Hollande, the French president, wants to avoid any treaty change that might split his Socialist party in a subsequent referendum.

Mr Steinbrück does not want to offend Mr Hollande either, as a fellow socialist leader. But there are limits to how far he will go to demonstrate solidarity with the French leader.

On the divisive subject of austerity versus growth, the SPD candidate is determined not to be painted as an irresponsible supporter of deficit-financed spending, any more than Ms Merkel.

Whatever hopes there may be in other eurozone capitals for a post-election change in German attitudes in favour of faster growth and less austerity in the monetary union, no big shift seems likely from any future coalition.

Demographic crisis pushes outsiders to fill jobs

Immigration

As populations age, foreign workers have become an economic necessity, says *Norma Cohen*

The recent suicide of Russian opposition activist Alexander Dolmatov in a Rotterdam detention centre after he was refused political asylum reopened the festering wound that immigration policy has become, both in the Netherlands and in Europe more widely.

Mr Dolmatov was wanted by Russian authorities for his role in anti-Putin demonstrations and the Netherlands has long been a natural destination for asylum seekers. But over the past decade, Dutch leaders have been under fire for lenient immigration policies from far-right politicians – as have their counterparts in other European states – and governments across the continent, and in Britain, have vowed to crack down.

The calls for tougher immigration laws come with Europe still stuck in post-crash austerity, facing cutbacks to services for citizens and unemployment rates of 25 per cent and higher in countries such as Spain.

The irony, economists say, is that immigration can and does boost economic development and has benefited host countries for many generations. Academic research suggests that migrants bring new skills to countries that may have a shortage, that they take jobs in areas of the economy that natives do not wish to do and that they are an increasingly significant portion of the working age population in several European states where natives of similar ages are on the decline.

Indeed, this last fact is perhaps the most salient. According to the latest data from Eurostat, the EU's statistics office, Europe's workforce is ageing. The median age in the 27 nations that make up the enlarged EU is 41.5 years, up from 35.7 in 1992. In Germany, it is 45.

Data from Eurostat show why, despite rising hostility in some quarters, much of Europe is likely to experience continuing growth in immigration. What is known as the old age dependency ratio – the number of workers available to support those too old to work – is falling.

Professor John Salt, head of the migration research unit at University College London, says age is a key difference between immigrants and native population. "Migrants tend to be younger and may be married with young children," he says. "But native populations tend to be older. There is no meeting of the generations."

Spain is a case in point. While it had about five workers to support each elderly person in 1992, now it has just under four. And, while there are signs that immigration has slowed since 2008, the foreign population of Spain has roughly tripled to just under 6m over the past 12 years.

Doing jobs locals do not want

Edward Hugh, a Barcelona-based economist specialising in demography, says that Spain highlights the type of population shift that has made migrants an economic necessity, despite unemployment of over 25 per cent.

"People are coming here at the moment – especially women – to look after old people," says Mr Hugh. Caring for the frail, he says, continues to attract migrants from poorer Latin American nations because it is employment that native Spaniards disdain.

Philippe Fargues, director of the migration policy centre at the European University Institute, points to the conflicting forces driving migration in Europe. "On one side, you have an economic crisis which has fuelled anti-immigrant sentiments everywhere in Europe," he says. "On the other side, you have a demographic crisis."

Countries such as Moldova and Ukraine are exporting female migrants in their 30s and 40s to more developed European states where they are filling increasing numbers of jobs in healthcare.

Jean-Christophe Dumont, head of the international migration division at the OECD, says about a quarter of immigrants are concentrated in jobs that represent declining occupations. "Older people are retiring and young people do not want to take up those jobs because they see no future in them," says Mr Dumont.

OECD research suggests that anti-immigrant sentiments vary widely across Europe. Scandinavian countries, for example, tend to attract higher percentages of humanitarian migrants. Scandinavia, however, has relatively restrictive labour markets, making employment opportunities more limited.

Britain, with its open labour market, attracts economic migrants and its non-native population has grown at one of the fastest rates in Europe in the past decade. Surveys between 2008-10 show anti-immigrant sentiment in the UK among the strongest anywhere, with 23 per cent of those questioned saying it is the "most important issue facing the country".

According to Prof Salt, steps to help migrants learn the native language are the best means of achieving more rapid integration of immigrant communities.

Mr Dumont says governments have a role to play. "It is necessary that information that is available to the public is transparent. That is so the discourse on migration is knowledgeable."

Quest for passport to a better life triggers debate on liberties

Citizenship

Free movement as a right within the community is in question, writes *Peggy Hollinger*

What does it take to become a citizen of the EU? In Cyprus, about €3m.

The proposition last month from Cypriot president Nikos Anastasiades to sell passports to wealthy Russians – in effect allowing them to buy their way into the EU – has raised pressing questions about the nature of European citizenship. Though member states have long traded passports for investment, the pressures of financial crisis have stretched the concept of European citizenship to its limits.

Member states such as Britain, Germany, Austria and the Netherlands are lobbying for constraints on rights once considered fundamental, even on the founding principle of free movement. Newer members, such as Hungary, have been rebuked for trying to undo liberties agreed in the accession process.

"It used to be that being in the EU was a guarantee of a certain set of rights but these are now in question," says Jordi Vaquer, director of Open Society Initiative for Europe, a think-tank. "There has been an erosion of the values that were associated with EU citizenship."

When the idea of a shared citizenship was first set out in the Maastricht treaty in 1992, the aim was simple. It was to break down the barriers that kept workers from moving from countries with no jobs to those with labour shortages.

Over the past 20 years, however, possession of an EU passport has increasingly brought social rights, such as health or welfare benefits. It is these which are being challenged, as the crisis sparks fears in northern Europe about a fresh wave of migrants from the south. Controversy over "poverty migration" now focuses on EU citizens, rather than those from underdeveloped countries.

It is not just the financial crisis that has caused member states to review some citizenship rights, argues Claire Kilpatrick, law professor at the European University Institute. "Enlargement put enormous pressure on what was fundamental EU law," she says. "Free movement rights have become more politicised."

Some 400,000 Poles moved to the UK after their country acceded in 2004. That experience has sparked profound anxiety over a potential influx of Romanian and Bulgarian migrants when constraints on these new EU citizens are lifted next year. Alert to the dangers, Brussels in 2011 launched infringement procedures against 12 member states for failure to translate Europe's free movement directive into national law. Some have since done so. Others have promised action. Yet, despite its pledge, Britain was last year rebuked for hindering Romanian applications for registration certificates.

"Free movement is the cornerstone of EU citizenship," says Mina Andreeva, spokesperson for Viviane Reding, Europe's justice commissioner. "Europeans consistently cite the freedom to live, study, work and holiday in another EU country as the most positive aspect of the union."

The commission intends to expand that mobility by recommending that member states should extend the duration of unemployment benefits to their own citizens who seek work in another country. At present, an EU citizen has the right to three months' payment while seeking work in another EU state. A survey by the Commission found that most Europeans would like this extended to six months or more, given that on average it takes 16 months to find work in a host country. "We see labour mobility as a potential solution to the crisis," says Ms Andreeva.

> 'There has been an erosion of the values that were associated with EU citizenship'

The proposal may be controversial. Most EU states are cracking down on benefits, rather than extending them. There are signs that even the European Court of Justice, which has done more to expand the notion of citizenship than any other EU institution, is beginning to recognise the political limits to solidarity. No longer is an EU passport on its own a guarantee of social benefits. Links have to be shown to the host country, such as having worked or lived there.

These developments have led some to declare the demise of EU citizenship. "There is now a climate of adversarialism as well as a sense of irrelevance attaching itself to the whole issue," argues Jo Shaw, professor at the Edinburgh law school, in a working paper.

Open Society's Mr Vaquer disagrees. Despite political controversy, laws have not been undone and Brussels is not just holding the line. It wants to expand political and consumer rights. Weakening commitment to a common citizenship "is a matter of perception", he says. "And because it is about perception, it can be reversed."