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Perspectives for the Eurozone, Short Term and Long Term

Introduction

For a common currency area to be fully successful over a long period of time, it must meet several economic, institutional and political conditions. From the day the euro was introduced on 1 January 1999, it was widely recognised that there might, and even certainly would be problems in meeting all these conditions in the euro area. Still, until the arrival of the world financial crisis in the summer of 2008, the euro monetary union had functioned quite well, perhaps even better than might have been expected.

The current crisis has a number of causes. Perhaps the three most important are excessive public debt in some eurozone countries, excessive wage increases that resulted in the loss of competitiveness by those same countries or other eurozone states, and excessive risk-taking by some segments of the banking sector, which resulted in excessive private debt in some of the member countries.

A significant part of the confusion in the debate concerning the present crisis in the eurozone and the needed responses to it comes from the uncertainty about the weight of the external shock in causing the crisis versus the weight of the long-standing internal problems of the eurozone itself. After clarifying

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1 This paper has been written at the invitation of Dr Marcin Zaborowski, Director of the Polish Institute of International Affairs and Editor-in-Chief of this Quarterly. I would like to thank Alberto Chilosi, Marek Dąbrowski, Stefan Kawalec, Kazimierz Marcinkiewicz, Andrzej Olechowski, Dariusz Rosati, Adam Szyszka, Paweł Wojciechowski and Cezary Wójcik for their helpful comments on earlier drafts of the paper. I also wish to acknowledge with thanks suggestions concerning grammar and style by Kacper Rękawek, Brien Barnett and Michael S. Gomulka.


3 Much of that excessive private debt was related to the housing bubble, and this in turn, at least in the USA, was apparently caused mainly by institutional and policy measures of the U.S. government. See: P. Dobrowolski, A. Kondratowicz, “Unreliable Markets, Bad Economists, and Good Politicians: The Sources of the 2007–2009 Financial Crisis in the USA,” in: M. Guzek (ed.) Ekonomia i polityka w kryzysie, Uczelnia Lazarskiego, Warszawa, 2012, for an excellent statistical and econometric evidence in support of that view.
somewhat the relative weights of the two causes, I shall discuss possible remedies for these internal problems. This discussion falls into two parts. The first concerns changes that need to be introduced urgently in order to contain the crisis. Here, the controversial policy aspect relates to the need for international solidarity versus the concern about moral hazards, and therefore the necessity for national fiscal and banking discipline. All these should take into account limitations imposed by the present political realities. I also will highlight the important informational and disciplinary role played by financial markets. The second part deals with the longer term and the identification of reforms needed to reduce substantially the risk of a similar crisis in the future.

Last, I shall discuss some of the implications of the crisis for Poland and other prospective members of the eurozone. These implications concern entry conditions to the eurozone—whether they should be much more severe; and also the likely gains from entry—how much they differ from those estimated in the last report by the National Bank of Poland (Narodowy Bank Polski, or NBP). Given the limited space and focus of the paper on the eurozone crisis, I am going to discuss only the former, and only briefly.\textsuperscript{4}

This paper does not discuss the option of the so-called controlled decomposition of the eurozone.\textsuperscript{5} The main reason is that while uncontrolled decomposition of the eurozone is possible at some, hopefully rather distant point in the future, controlled decomposition is in my view not an option likely to happen, neither now nor in the future.

The Intended Integration Roles, Political and Economic, of the Euro for the European Union

The founding fathers of the European Union (EU) project were fundamentally vague about its ultimate institutional and political shape. However, they were quite clear about its needed direction of integration for changes in the area of markets of all kinds, especially those for internationally traded goods and


financial products, as well as for labour. But at some point, it was realised that a
common currency, while itself not a necessary pillar of a common market, could,
and if successful would assist in the process of the economic and political
integration of the EU. The inspiration may have come from economists such as
Robert A. Mundell, whose work (for which he was awarded a Nobel Prize)
indicated that the project to set up a common monetary system based on a single
currency is institutionally feasible and, under some conditions (the most
principal of which was the ability to have national fiscal policies sufficiently
flexible and stability-oriented), would be economically beneficial. The
elimination of the exchange rate risk would stimulate trade and investment
within the currency area and, therefore, increase market competition and
economic efficiency. The actual developments since 1999 have been in line with
these expectations.

For the political leaders of Europe, seeking to establish an economic and
political order conducive to permanent peace after two exceptionally barbaric
and destructive wars, the social and political implications of this increased
economic integration might had been even more important. Integration would
enhance the interdependence of the nations of the EU, and this would strengthen
the spirit of political cooperation across borders and weaken the incentive for
military competition among states. Moreover, a common currency, if it were to
help economic integration, would also begin to form a common European
identity, which over generations could provide the necessary glue to cultural
integration, helping with political cooperation, and leading in time, perhaps, to a
political integration of some kind. Developments since 1999 have by and large
also been in line with these expectations.

From the Polish perspective, it is interesting that the less-developed member
countries of the monetary union were expected to benefit more strongly—those
which economists call emerging or catching-up countries. Poland and other new
members of the EU, as well as prospective members, such as Turkey and
Ukraine, belong to that category. These countries enjoy what U.S. economic
historian Alexander Gerschenkron half a century ago called “advantages of
backwardness.”6 These advantages are potent only when the countries in
question are capable of generating or bringing about an international transfer of
new products and technologies from their more developed partners. Such

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6 See: A. Gerschenkron, *Economic Backwardness in Historical Perspective*, Harvard University
transfers are typically proportional to investments in technology-intensive projects. Membership in the monetary union stimulates foreign direct investments and gives domestic firms easier access to foreign savings at lower interest rates. The result should be a higher growth rate and therefore faster real convergence of less-developed member countries with the most-developed ones. Developments since 1999 have shown that these gains may be illusive, that is, they are possible but not certain. Indeed, lower interest rates may also stimulate consumption or investment in housing rather than technology-intensive projects, leading in some circumstances to bubbles and excessive (private and public) debts.

Bubbles or excessive debts can produce instability. When combined, they are capable of causing a particularly severe illness. It has become evident that this illness is a problem, one among several, against which some new measures must be developed if the stability of the eurozone is not to suffer again in the future.

The Causes of the Current Crisis

A currency crisis is usually understood to be a sudden decline in confidence in a given currency, resulting in its substantial depreciation against the world’s leading currencies. Nothing like that has happened with the euro so far. However, the concern is that, given the political and institutional constraints, the exceptionally large accumulation of public and private debt in some countries in the eurozone will cause a financial crisis in those countries that will spread to engulf the whole area, leading at some point to a large decline in confidence in the euro. Right now, we have therefore only a severe fiscal crisis in some eurozone countries and a potential euro crisis.

Given the exceptionally destabilising role of Greece to the eurozone, I shall discuss this particular cause of the eurozone crisis separately. It may be useful to first discuss several causes of the crisis of a general nature.

The problems as defined by David Cameron and George Soros: incorrect evaluations or serious errors in the institutional architecture. David Cameron, the British prime minister, argued recently in Davos that successful currency unions had vital features in common: a lender of last resort for the state, economic integration and flexibility to deal with shocks, fiscal transfers and collective debt. He said: “Currently it’s not that the eurozone doesn’t have all of these; it’s that it doesn’t have any of these.”

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7 See: “1789 and All That,” The Economist, 11–17 February 2012.
The European Central Bank (ECB) is indeed not supposed to be a lender of last resort for the state. This is partly because there is no federal state since the eurozone is essentially a collection of independent states. The credibility of the central bank in any country is in normal times enhanced by a clear separation of responsibilities for macroeconomic stability between it and the government or parliament. This is the kind of separation Poland also enjoys. If the ECB were a lender of last resort for all the eurozone Member States, its ability to keep inflation low at relatively low interest rates would be seriously undermined; it probably would just not be possible. This is because both the Member States and financial markets would know that the constraint to keep national budget deficits low would be less binding, and it would be possible in many cases and often to have a condition in which a soft budget constraint would arise. This type of danger is less potent if fiscal matters are in the hands of a single state, but with many independent states and with the ECB as a lender of last resort, the responsibility for fiscal stability in the entire eurozone would be diffused, leading to a potentially gigantic freerider problem and, hence, increasing substantially the risk of massive macrofinancial instabilities.

During the last two years of the euro crisis, the ECB has nevertheless acted from time to time to limit the cost of servicing public debt. In principle, it may act in liquidity crises, but not in real solvency crises. Thus, the ECB can be a lender of last resort, but as an exception and in circumstances it deems appropriate, and only, or mainly indirectly, by lending money at favourable rates to commercial banks. There is no need to change this important pillar of the present institutional arrangement. Still, there may be the need to clarify the ECB mandate for this aspect in its Charter.

The second apparent weakness, according to Cameron, concerns economic integration and flexibility, that is, whether a monetary union is sufficiently developed in these two respects to absorb large price and quantity shocks at low cost. The eurozone essentially meets the requirement of high economic integration, but several (if not most) member countries have not met the flexibility

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8 Since May 2010 the ECB operates so-called Securities Market Programme. Under this programme, it buys, from time to time, typically in the secondary market, government bonds of the Member countries which happen to be under exceptionally large pressure from financial markets to offer these bonds at very high interest rates, unsustainable for those countries in the longer term. According to the Polish PM’s Economic Council Bulletin of 5 June 2012, total purchases of such bonds under this Programme from its start until 1 June 2012 amounted to 212 billion euros. The ECB also occasionally accepts such bonds from banks as collateral in its attempt to save banks from ill-effects of, effectively, junk securities.
requirement. Indeed, to compensate for the absence of exchange rate flexibility, more flexibility is required in the two other core policy areas: public finance and the labour market. If budgets are to be in deficit during a recession, they should, given near stability of the long-term EU GDP and the need to lower the debt/GDP ratios, be in surplus during a boom. That is what was supposed to happen under the provisions of the Stability and Growth Pact, but did not happen in practice. In turn, larger flexibility in the labour market is needed to keep the growth of unit labour costs at a similar pace in all countries of the eurozone and, therefore, international product competitiveness at a similar level. Once that competitiveness is lost on a large scale in any particular country, it is difficult to regain it under a fixed exchange rate regime, leading to a large external debt or prolonged recession in that country. This loss of competitiveness is what apparently happened in several countries of the eurozone in the period 2000–2008, well before the start of the world financial crisis in the summer of 2008 and the start of the eurozone crisis in 2010.

Fiscal and labour market policies have been, and for many years will remain, the responsibility of national governments and national parliaments. National budgets represent typically about 50% of national GDPs, while the common EU budget is just about 1% of EU GDP. Misguided national macroeconomic policies have had negative external effects on the entire eurozone. But they are also costly for individual countries. It is important that Member States have no incentive to deviate from policies required for stability of their countries and, consequently, that of the eurozone as a whole. Any arrangement concerning international fiscal transfers and collective debt, the lack of which Cameron lists as another problem, must be subordinated to that central requirement.

The problems listed by George Soros are similar to those discussed above, along with insufficient regard to incentives for all Member States to care about short-term stability and long-term sustainability. Soros makes the judgment that “the euro crisis is a direct consequence of the crash of 2008”, after which “the entire financial system … had to be put on artificial life support.” However, Germany declared that guaranties to financial institutions, offered by European finance ministers as early as November 2008, should be “exercised by each

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9 These are so called general government or public sector budgets, which include also local governments and social security and health funds. Central government budgets are typically much smaller, some 20–40% of GDP.

10 More on that in the later part of the article.
European state individually, not by the EU or the eurozone acting as a whole.” According to Soros, this “sowed the seeds of the euro crisis because it revealed and activated a hidden weakness in the construction of the euro: the lack of a common treasury.” He notes that an equivalent to some mortgages in the U.S. subprime crisis has been another apparently riskless asset, namely the bonds issued by some European governments. Soros would like the newly created institutions—the European Financial Stability Facility (EFSF, created in May 2010) and its successor, the European Stability Mechanism (ESM, after 2013)—“to provide a safety net for the eurozone as a whole.” This would require their transformation into “a full-fledged European treasury, … with the power to tax and therefore to borrow.”

This Soros recommendation, if implemented, would probably be effective in returning confidence to the financial markets for suspect government bonds—those for which high risk premiums are demanded. But his recommendation is unlikely to be implemented for rather obvious political reasons. Moreover, and equally important, if his plan were to succeed in the long run, all fiscal affairs of the eurozone member countries would have to be taken over by the new treasury. This would require another miracle: the creation now, or quite soon, of a single federal eurostate, possibly along the U.S. model.

The exceptional case of Greece. As noted previously, the euro crisis that erupted in 2010 was ignited by the wider financial sector crisis that occurred outside the eurozone in 2008–2009, mainly in the U.S. and the UK. However, it erupted only in some countries of the eurozone, and mainly in response to the accumulation of large debts, both public and private, over several years before 2008. In the years 2007–2008 there were two groups of countries in Europe on the brink of macrofinancial instability, defined as an excessive, unsustainable fiscal deficit and/or debt, or private debt, or current account deficit, or some combination of these. One group was outside the eurozone altogether: the three Baltic countries, Bulgaria, Hungary and Romania. The other group was the GIIPS countries: Greece, Ireland, Italy, Portugal and Spain. However, during the period since 2008, the Baltic countries and Bulgaria responded to their crises with exceptionally strong measures. They have consequently regained market confidence. One of them (Estonia) was even able to join the eurozone from the beginning of 2011. In the eurozone itself, Germany and several other “strong”

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member countries have retained the full confidence of world financial markets. Consequently, the euro has so far remained a strong currency, and interest rates on government bonds of these “strong” countries have not increased but have fallen to historically very low levels.

Of all the countries in distress, Greece is exceptional. The country adopted the euro on 1 January 2001, though the ratio of public debt to GDP in 2001, at 103.7%, was already far in excess of the 60% Maastricht limit. During the last few years, it has been the only country with both large public and private debts in relation to GDP, the consequences of a large government budget and large balance of payments deficits over many years. Moreover, in the period 2001–2008, exceptionally rapid increases in nominal wages led to a substantial loss of international competitiveness, and one much worse than elsewhere in Europe. Across the whole Greek economy, these wage increases were financed to a significant extent by foreign credit. A clear institutional failure on the part of the EU institutions and banks was in allowing Greece to run up such large foreign debts, not to mention turning a blind eye to Greece’s persistent falsification of its public accounts.

How to Limit the Risk of a Possible Chain Reaction Disintegration of the Monetary Union?

Whatever the causes of Greece’s present predicament, the question remains about what the economically right and politically feasible policy response to it is now—a policy that would be well designed to both help Greece and reduce the risk of a destabilising chain reaction. There is also the question about the right institutional response, one that would hopefully strengthen the eurozone by reducing the risk of a similar crisis in the future.

Short-term responses to the crisis: solidarity versus discipline in the eurozone. A reference to solidarity has in Poland positive political connotations, associated with the birth of the Solidarity movement in 1980 and the subsequent peaceful revolution. In Germany, this particular term must by now be associated mainly with something completely different, namely with the so-called solidarity tax, imposed on West Germans to finance the reconstruction of East Germany, following the collapse of the Berlin Wall in late 1989. That tax financed transfers to East Germany that have been quite substantial, some €2 trillion since 1990.\(^\text{12}\)

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\(^\text{12}\) Author’s own estimate.
However, the eurozone is not a nation state and Greece is not East Germany. The demand of a large transfer of resources from Germany to Greece on the principle of European solidarity cannot be politically popular in Germany and may even be seen, quite correctly, as economically irrational and morally unacceptable. The irrationality argument is founded on the premise that if Greece is rewarded for its past policy of overspending and overborrowing, then this could be seen by some other countries as an incentive to conduct similar policies. Such an incentive would therefore have the potential for moral hazards on a scale large enough to lead to the total and uncontrolled decomposition of the eurozone.

In weaker countries in the EU, including Poland, it is popular among policy makers to refer, perhaps for internal political reasons, to the notion of solidarity in order to motivate proposals that would alleviate the fiscal problems of Greece and other heavily indebted countries at the cost of other, stronger countries. But what may be good politics on national grounds is, in this case, a dangerous populism for the EU.

If Greece and the other eurozone countries in distress had not been helped, they would have already been in no position to service their public debt. A disorderly bankruptcy would follow, one probably extremely costly for the countries in question and also possibly capable of triggering a fairly large-scale recession in the EU. The assistance provided to Greece by the ECB, some members of the eurozone, and the International Monetary Fund (IMF) is keeping these countries afloat, therefore limiting the social and political costs of the present crisis.

But in order to avoid the development of a potentially highly destabilising moral hazard mechanism, such assistance must be quite limited and, moreover, would make economic sense only if the countries in trouble themselves adopt sufficiently strong measures to deal with their excessive debts and low competitiveness. This should have been the message of Poland when it held the EU presidency and it should, in my view, be its policy now.

As for Greece, an orderly default has already taken place; about half of the country’s public debt to private financial institutions, the equivalent of some 40% of GDP, has been written off. The contractionary fiscal measures adopted by Greece, partly as a condition of external assistance, are expected to bring about a fall in the country’s GDP by some 20%. The unemployment rate is likely to stay at 20–25 % for several years. These socially costly developments will, however, also have several desired long-term effects: regaining competitiveness
through lower wage costs, increasing net exports, and instilling in the memory of the nation and its political elite concern for financial responsibility. Important also are the internal measures on the supply side, limiting wasteful rents on positional goods and modernising the fiscal administration in order to reduce corruption and tax avoidance.

The golden rule for external assistance during such a crisis is (in my interpretation) the well-tested IMF principle: the assistance should be large enough to induce substantial reforms by distressed countries while avoiding deep recessions, but low enough to be politically acceptable to donor countries and incapable of encouraging the development and spread of destabilising moral hazards.

The countries of the eurozone, together with the ECB and the IMF, are essentially following this golden rule. Leaving the euro would probably make it easier for Greece and Portugal to regain competitiveness fast. This radical alternative option is open to them. But it would be very costly to these countries, therefore unlikely to be willingly embraced. However, while the countries in distress apparently much prefer to stay in the eurozone, some of them, notably Greece, may refuse to implement the conditions on which the external assistance has been offered and is being provided. This raises the prospect, with respect to Greece, of the discontinuation of such assistance and the forced withdrawal from the eurozone. If this were to happen, it should by now have probably quite limited negative impact on the eurozone in the short run and rather positive impact in the long term.

The creation of the European Stability Mechanism (ESM), with capital now of €500 billion and ultimately of €800 billion, has been the key stabilising response of the eurozone for the medium and long terms. The ESM should, from the beginning of 2013, take over from the ECB the role of principal partner of the IMF in providing conditional assistance to the countries in distress.

**What long-term repairs are needed?** In the economic behaviour of states and nations, decisions are often taken on the basis of short-term considerations, and as a result are irrational, sometimes even self-destructive, in the medium or long terms. Rules and incentives are needed to remove this inconsistency in favour of longer-term interests and against short-term temptations. Since states

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13 In the case of Greece, the recent approximate estimate of the country’s central bank is that the further fall of GDP resulting from the exit from the euro would be some 20–25%, bringing the cumulative fall of GDP and the effective unemployment rate to some 35–40%.
are independent, the realistic aim is not to remove completely short-term behaviour, but rather to reduce the likelihood of such behaviour.

In the case of the eurozone, the key question from the start was whether a common monetary policy and a single currency can be sustained without a common fiscal policy decided by the European Parliament or another single political authority, or, alternatively, whether the agreed Maastricht criteria would be a sufficient constraint on national fiscal policies to insure good coordination and stability at the EU level. The history of the eurozone so far suggests that despite some 60 cases when the criteria were breached, by and large they were met sufficiently for the coordination of the two types of policies, monetary and fiscal, to have been effective most of the time.\(^\text{14}\) However, it is still legitimate to ask whether in light of recent experience the present Maastricht criteria need to be changed, and also whether the disciplinary system to ensure compliance has been sufficiently strong.

The case of Greece, and to an extent also some other countries, shows that the present stability-oriented coordination and disciplinary system needs to undergo significant repairs. This need has been recognised by EU leaders. Their response so far has been the so-called fiscal pact. Among the changes in the Maastricht and EU Treaties that, to me, seem warranted are as follows:

1. Two new stability conditions should be considered, one with respect to total (public and private) external debt and the other to the current account balance, both in relation to GDP. Alternatively, the TARGET instrument of the ECB should be reformed along the U.S. model.\(^\text{15}\) The new EU initiative, the Excessive Imbalance Procedure (EIP), meets this problem to some extent, but may not be sufficient.

2. The European Commission, in cooperation with the European Court of Justice, should have the power to penalise countries that do not meet some or all of the Maastricht criteria. The penalties should be nearly automatic, and maximum penalties should be substantial and may include lowering or even stopping transfers from the EU budget to the country.

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14 One may also argue, as does Alberto Chilosi in a comment on an earlier version of this paper, that the “destruction of Maastricht discipline by Schroeder and Chirac in 2003–2005, with the collaboration of the Italian government, has been crucial in producing the present crisis.”

15 The term TARGET is an acronym that stands for Trans-European Automated Real-Time Gross Settlement Express Transfer. This refers to the eurozone transaction settlement system through which commercial banks of one member country make payments to commercial banks of another member country.
3. The European Union Treaty should be amended to include the extreme possibility that if Maastricht stability criteria are violated fairly systematically and strongly, a country may be expelled from the eurozone. The exit rules should be clearly specified so that the removal threat is credible, in which case the likelihood of such exits would be small. As Rosati noted in a personal comment on an earlier version of this paper, this exit possibility would be needed “if the monetary union implies a commonly financed stability mechanism.” Alternatively, and perhaps as a first step in that direction, the possibility should exist to suspend the voting rights of such a country in the Council of Ministers and the ECB.

4. The EU budget should be gradually, but eventually substantially, increased in relation to the EU’s GDP, from the present level of about 1%. This change would be mainly in order to finance Europe-wide investment projects in such areas as infrastructure, energy, research, defence, and environment. At the same time, in order to gain political acceptability for a larger EU budget, some limits should be imposed on the size of member countries’ net transfers to the EU common budget.

With respect to the first reform, it would recognise the fact that not only public (domestic and foreign) debt but also total external debt, when excessive, can be a source of macroeconomic instability. Under the present system, balance of payments deficits are not limited by any criterion. By summer 2011, the GIIPS countries accumulated liabilities of €404 billion. Technically these liabilities represent a part of gross government debt, but they are not officially counted as such. This would not be the case if the banks were under strict ECB, rather than national supervision. In August 2011, this hidden debt amounted to 76% of GDP for Ireland, 44% for Greece, and 35% for Portugal. These are big numbers, capable of influencing the evaluation by financial markets of a country’s debt repayment ability, hence their credibility. Since imports are done largely by the private sector, there are good economic reasons for treating these liabilities as a separate category of national debt rather than simply as a part of public debt. A large current account deficit should be a signal for the

16 Author’s private communication with Dariusz Rosati.
government that either incomes of the population are excessive or government expenditure is too large (or taxes are insufficient), and should induce it to take some corrective measures.

As for the second reform, it is important that the disciplinary mechanism of enforcement is strong. The practice under the present system was one of virtually no penalties for even serious and persistent violations of members’ treaty obligations.

With the third reform, it is important to correct the present situation when the welfare of the entire eurozone depends on the goodwill of each and every member, including those willing to misbehave. The membership of the eurozone, at 17, is already quite large and expected to be much larger, possibly up to 25. Since member countries are politically independent, the practice has shown that one or two of them may sooner or later decide not to meet important treaty obligations and yet insist on membership.

Finally, the fourth reform means that increasing the integration of the economies of the EU provides economic justification for an eventually much bigger role for the EU budget. But for this to happen, net transfers amongst countries should be subjected to clear and politically acceptable limits. This budget should still be a small fraction of national public spending, and therefore cannot play any significant role as a fiscal (automatic or not) stabiliser.

**Questions About the Timing and Distribution of Repair Costs**

The assets and liabilities of the eurozone financial system are so intermingled on the basis of a common currency that a “breakdown of the euro would cause a meltdown beyond the capacity of the authorities to contain [it].”\(^{19}\) In the recent study “Euro break-up: the consequences,” three UBS economists estimated the economic cost of a euro break-up to be in the first year about 40–50% of GDP for a country in the GIIPS group and some 20–25% of GDP for a strong country such as Germany.\(^{20}\) These estimates may well be exaggerated but it needs to be accepted that the costs would most certainly be exceptionally large. Since this appears to be a consensus view, the reform option is widely seen as socially superior to a break-up. Most repairs have to be done in GIIPS countries. This suggests they should take most of the necessary action and

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\(^{19}\) G. Soros, “Does the Euro Have a Future?,” *op. cit.*

absorb most of the economic, social and political costs of such reforms. External assistance can be large, but mainly conditional and in the form of credits rather than outright transfers. However, the resistance (in the short-run) to costly reforms in weak countries and the need to take swift stabilising measures puts pressure on strong countries to contribute more than is rational given long-term considerations. A Russian roulette situation has developed. Soros warns that if EU authorities persist in their current course of trying to buy time, “this will have incalculable political consequences.” But, in his view, “the path that leads to a solution has to be found in Germany, which, as the EU’s largest and highest-rated creditor country, has been thrust into the position of deciding the future of Europe.”

However, the arguments underlying the “golden rule” suggest that Germany and other so-called strong countries may be right in resisting short-term political pressures, and in insisting on introducing what is economically rational in the long-term. This German/European Commission strategy is more time consuming, so it would have to be safeguarded by the technical ability and actual willingness of the ECB to stabilise financial markets as quickly and as strongly as might be required in the short term. The ECB did this in 2011, mainly by providing a large amount of liquidity to the eurozone financial sector at a very low interest rate. There is, however, a second pillar to this strategy. That is, to prepare for the possibility of a voluntary or forced exit of Greece and possibly Portugal from the eurozone. Such an exit need not take place, and probably will not take place with respect to Portugal, but the probability of it taking place with respect to Greece is high, perhaps its exit is inevitable.

The main targets of such a strategy are Italy and Spain. Their financial position is much better than Greece, and the pressure on them to reform must be maintained in order to firmly establish important behavioural rules for the future stability of the entire eurozone. These two countries and their national debts are so big anyway that, given the political and institutional constraints that prevent large inter-Member State transfers, they must take on themselves the main burden of adjustment if the entire euro project is to survive.

Therefore, while the keys to success in removing the present fiscal difficulties lie in all countries of the eurozone, the most important ones are in Rome and Madrid rather than in Berlin. The strong call by Polish Foreign Minister Radosław Sikorski in his Berlin lecture for Germany to assume a more

\footnote{Ibidem.}
active leadership role in the EU is therefore somewhat double edged. It may be interpreted as full and unmitigated acceptance by Poland of Germany’s much-enhanced position within the EU.\textsuperscript{22} But it may also be interpreted as a demand to transfer much more resources from Germany to countries in distress. The policy as seen under this second, probably intended, interpretation is neither realistic nor quite what is needed.

Also open to criticism have been public statements by Jacek Rostowski, Poland’s finance minister, who called in the European Parliament and on other occasions for the ECB (and for the Polish national bank) to assist countries in distress by direct and sufficiently large purchases of their debts. The ECB can and should help in order to give states the time needed to implement necessary reforms, but this assistance must be at the ECB’s own initiative and limited in size in order to maintain pressure on governments and preserve the ECB’s credibility.

As I noted in the introduction, a major cause of the 2008–2009 world financial crisis and the 2010–2011 euro crisis, has been the unusually large blunders committed by the private sector, especially by banks and rating agencies, in the evaluation of risk. Private owners and investors must pay a large share of the implied costs for these blunders. It is therefore also important to limit to a necessary minimum the transfers of resources from the public sector to the private sector.

The U.S. Experience with a Monetary Union and Its Implications for the Eurozone

The German economists H. W. Sinn and T. Wollmershaeuser argue that “Europe might wish to think about adopting the U.S. rules about running a monetary union. After all, these rules have been distilled from a long historical trial-and-error process, and have been shown to function. It is not always necessary to re-invent the wheel.”\textsuperscript{23} The institutional structure and methods of the ECB’s operation can indeed be improved by borrowing from the U.S. system of 12 Federal Reserve districts. Specific proposals have been made by these two economists with respect to the TARGET facility, and by Willem Buiter\textsuperscript{24} with

\textsuperscript{23} H. W. Sinn, T. Wollmershaeuser, “Target Loans…,” op. cit., p. 29.
\textsuperscript{24} W. Buiter, “Is the Eurozone at Risk of Turning into the Rouble Zone?,” Citigroup Global Markets, 13 February 2012.
respect to the conduct of the common monetary, credit, and liquidity policy of the ECB and its 17 national central banks.

However, given the key causes of the current crisis, I am concerned mainly about how to defend against the potentially destabilising impact on monetary developments of the absence of a single treasury and a single political authority. The U.S. is a federation of states, but it also has a strong federal government. In 1913, the Federal Reserve was set up to act as lender of last resort. *The Economist* notes that “The 1930’s slump led to much-expanded federal spending under Roosevelt. American states are now constrained by balanced budget rules, but the federal government borrows hugely to bolster demand.” It comments that “The eurozone has, in effect, tried to create America’s no bail-out doctrine of 1940 with neither Hamilton’s federal structure nor Roosevelt’s counter-cyclical tools. Euro members are walking on a wobbly tightrope without a safety net. When the storm has blown, they have found themselves tied together by the financial markets, meaning that if one were to fall, all would risk doing so.”

In the eurozone there is, of course, no strong central government and virtually no central budget. However, active fiscal policies can be, and are conducted by individual Member States. Their budgets are large and need not be balanced every year. Fiscal limitations apply only to structural deficits and cumulative public debts. The U.S. federal government can borrow from the Federal Reserve, but in practice it borrows mainly in domestic and international financial markets, similar to what the EU governments do. Therefore, while institutional differences between the U.S. and EU are indeed quite large, they are not so potent for the conduct of stability-friendly fiscal and monetary policies.

But since fiscal limitations in the EU are somewhat soft, and have proved too soft until now, the country risk may vary strongly. Taxes and expenditures are decided by national parliaments, not by the European Parliament. Therefore, the responsibility for debt servicing and debt repayment must be, and is taken wholly by individual member countries. This gives financial markets a very important independent role to play in disciplining the conduct of Member State fiscal policies. This role is more than merely supplementary to that conducted by

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25 “1789 and All That,” *op. cit.*

the European Commission, and is in fact fundamental. That is true even though financial markets react sometimes quite erratically. But public institutions may meet this problem by providing timely and good quality information to market participants.

The Fiscal Pact on Coordination and Governance

A new treaty on stability, coordination and governance, proposed on 31 January 2012, and an earlier “six-pack” package have been so far the main institutional responses of the political leaders of the EU to the present euro crisis. In a follow-up document, the European Commission explains the motivations behind these responses. It begins with a diagnosis that “fiscal imbalances and competitiveness divergences (have) developed in certain euro area countries (because) the EU relied largely on more or less voluntary coordination of policies.”

The studies of all major monetary unions show that a necessary condition for the success of such unions is solid fiscal discipline. The moral obligations of governments in the eurozone failed to provide that discipline. It is in fact somewhat surprising that these moral obligations were almost sufficient for so long. In the absence of the world financial crisis, the explosive material of excessive debt would be much smaller and may not have been ignited for some time.

On 7 September 2010, the EU Economic and Financial Affairs Council (ECOFIN) introduced the European Semester, which brought together the coordination processes of both the Stability and Growth Pact and the Broad Economic Guidelines under a single institutional framework. It is likely that “this initiative may help in strengthening ex-ante peer review mechanisms at the early stages of national budget planning.” The governance “six-pack” initiative, adopted by the European Parliament (EP) in October 2011, is intended to insure expanded surveillance by the EC of the economic policies of all Member States, and also impose tougher and automatic financial sanctions in response to non-compliance with the Maastricht criteria. Two new measures are important. One is that an Excessive Deficit Procedure can be launched, even if a

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deficit is below 3% of GDP, when the debt-to-GDP ratio exceeds 60%. The other measure is that when a euro-area Member State is in breach of the fiscal deficit criterion, the European Court of Justice can impose financial sanction of up to 0.1% of GDP. However, the risk is that the culprits are not going to pay. Freezing the payment from the EU budget would have more bite.

Are these measures sufficient to ensure fiscal discipline? Is there a risk of the EC turning into some kind of Central Planning Commission, a bureaucratic power restricting excessively the policy flexibility at the national level and the political rights of national parliaments?

We do not know the answer to the first question and the answer to the second question is almost certainly in the negative. Given the fact that the EU is and will continue to be a collection of essentially independent states, specific decisions on taxes and expenditures are, and will be taken at the national level. The roles of the EC and the EP in fiscal matters will continue to be largely informational and advisory. Whilst it is true that “Euro adoption will be associated with giving up more sovereignty than it has previously been expected,”30 the required shift in that direction probably will be fairly limited. The EU’s centre is going to have much stronger teeth, mainly in matters concerning compliance with stability criteria. The key provision is the obligation to put EU fiscal rules into the national legal framework, preferably at a constitutional level. This is how it should be. The centre will also have bigger financial resources for the purpose of intervening in financial markets in order to assist Member States in distress. However, the non-federalist structure of the EU rules out significant international transfers. This “fact of life” should become an unquestionable principle of intra-EU politics, ingrained in the thinking of political leaders as well as the EU population in general.

On January 1, 2011 three new EU institutions were established: the European Banking Authority for bank supervision, the European Securities and Markets Authority for the supervision of capital markets, and the European Insurance and Occupational Pensions Authority, to deal with insurance supervision. In addition, since November 2010 the European Systemic Risk Board has been in place. The EC has also informed in various communications that it intends to make credit ratings more reliable, to tighten rules on hedge funds, to curb banking pay practices that encourage recklessness, and to reform audit.

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The Global Context: 
the Build-up of Competitive Pressures from China and India

The recent emergence of China and India as large economic powers is beginning to change the world distribution of political power, eventually probably quite fundamentally and with substantial consequences for the conduct of international affairs. These changes are bound to have an impact on economic and political developments in Europe and will tend to provide a new incentive for stronger economic and political cooperation within the EU. How much time does the EU have to prepare itself to meet head-on the competition from these new world powers?

It may be useful to think of the most-developed countries at present, that is the old world (OW), as one entity. Belonging to that entity are the EU, the U.S., Japan, and Canada. Their combined population in 2010 was about 920 million people. The populations of China (1.34 billion) and India (1.2 billion) are of a similar order of magnitude. In terms of world GDP, in terms of purchasing power parity, the shares of the three entities in 2010 were approximately: 47.4% for the OW, 13.2% for China, and 5.5% for India.\(^{31}\) However, the OW still dominates almost completely in the production of internationally registered patents and the financial markets.\(^{32}\)

These relative positions are likely to change substantially by 2030, and fairly radically by 2050. China and India are so-called emerging countries—their economies growing for some time at rates in the range 6–10% per year.\(^ {33}\) The worldwide experience of catching up suggests that these kind of rates could be maintained for another 10–20 years for China and for some 20–30 years for India, at which time the rates begin falling gradually, perhaps even rapidly, to some 1–2% in terms of GDP per head, which is the range for the OW. Consequently, the (very) approximate shares of world GDP will be, in 2030: 35% for the OW, 25% for China and 10% for India, and in 2050: 25% for the

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\(^{32}\) In 2010, the EU accounted for 22% of the world GDP. This compares with 19% of the USA and 5.7% of Japan. While the productivity growth rate is likely to be about the same in the EU, USA and Japan, about 1–2% per annum, the GDP growth rate in the USA will be higher by some 1% on account of faster population growth.

\(^{33}\) See: J. Y. Lin, “China and the Global Economy: Remarks at the 20\(^{th}\) Anniversary of the University of Science and Technology,” Hong Kong, 23 March 2011, for an excellent account and analysis of the current relative position of China in the world economy and its catching-up progress.
OW, 20% for China and 15% for India. Given these shares, the countries of the OW would maintain global dominance in technological research and financial markets until 2030 but would see that lead much eroded by 2050.\textsuperscript{34}

Given this forecast, the build-up of competitive pressures from China and India on Europe will be fairly gradual, though ultimately very substantial. This gives us ample time to modernise the institutional architecture of the EU. But as the Polish foreign affairs minister recently noted in Berlin: “we must not stay idle when the world around us changes and new competitors come into play.”\textsuperscript{35}

By 2050, the less-developed countries of Central and Eastern Europe should also progress in their modernisation drive, to a level of technological and civilisation standard possibly not much lower than that of Western Europe.

**The Euro Strategy for Poland**

An EU with a common market can prosper without a common currency; it did so until 1999. However, the return to national currencies now would be extremely costly economically for several years for all EU countries, especially those in the eurozone. It is therefore reasonable to assume that the eurozone will eventually come out of the present crisis strengthened.

The EU is also a political project, and the common currency is to promote international political cooperation. The principal motivation for such cooperation has been, and is, to prevent the occurrence of wars from which Europe suffered so much for centuries. In the second half of the 20\textsuperscript{th} century, among the EU countries it was Poland and Germany which suffered most, much more than other important countries. Perhaps for that reason the popular support for the EU, including a further integration within it, is rather strong in those two countries. It is not surprising that Sikorski in his Berlin lecture declared that in the years to come, “the biggest threat to the security and welfare of Poland would be the collapse of the eurozone.”\textsuperscript{36}

The appropriate euro strategy for Poland must have two clear objectives. In the short term, the country should take a clear stand on how to deal with the present euro crisis. In the medium term, the country should conduct fiscal and

\textsuperscript{34} As for the year 2020, it is reasonable to assume that the world shares of the EU and USA will be about the same, somewhat less than 20%, and about the same as the share of China.

\textsuperscript{35} R. Sikorski, “Polska…,” *op. cit.*

\textsuperscript{36} *Ibidem.*
monetary policies that would enable it to join the eurozone relatively quickly, and as a strong member. It is now quite risky to suggest any timetable. But it would be sensible to assume that the eurozone will be ready for expansion in some 2–3 years. It may well take about that same time for Poland to be ready to enter the Exchange Rate Mechanism (ERM). It would thus appear that the earliest entry date is 2016 or 2017, possibly not later than 2020.

For both economic and political reasons it is, I think, important for Poland that Ukraine joins the EU. Ukraine is right now far from meeting membership criteria. But even when it meets the criteria, an expansion of this kind could be seen as somewhat destabilising. However, the balance of risk would change in favour of stability if Poland itself becomes a solid example.

This exemplary role should apply not just to the medium term, when Poland is attempting to meet the Maastricht and other criteria of entry into the eurozone, but also, perhaps even more importantly, to the long term, after the entry point. The conduct of policies after this point, and the institutional reforms needed to support them, should therefore become an important part of the country’s entire strategy of eurozone membership. This post-entry part should focus specifically on public finances, structural reforms, and the labour market, with the aim to maintain enhanced flexibilities more or less permanently, and on the financial sector, with the aim to insur against credit-financed demand bubbles in response to permanently lower nominal and, especially, real interest rates.

In the area of public finance, Poland (and the EU) has an excellent model to study and possibly adopt (at least some parts of it)—the Swedish fiscal policy of the last two decades. In the Polish labour market, there is a question about how to respond to the threat to stability from an expected large fall in the supply of new labour. The various pension reforms proposed recently by the government should help to meet this threat. Another policy response would be an activation of the still large labour reserve lying idle in the countryside, especially in the poorer parts of Poland. If these two responses proved to be insufficient, then another possibility to consider would be to open Poland somewhat more widely than it is at present to immigration from our eastern neighbours: Belarus and Ukraine. That kind of policy may also have beneficial implications in international foreign affairs by fostering closer cooperation and integration—economic, cultural, and political—in Central and Eastern Europe.
Conclusions

The large potential costs of a break-up of the eurozone are probably now large enough to induce policies and institutional reforms at both the national and EU levels that are needed to heal and strengthen the monetary union. Most of the needed reforms are at the national level in GIIPS countries. The reforms proposed so far at the EU level are a significant step in the right direction, but are probably insufficient. In particular, they do not prevent excessive growth of total, public plus private, foreign debt. I have suggested that in order to meet that threat, open limits on inter-country transfers of resources are needed. These would enhance stability and allow for an enlargement of the EU budget. Limits to such transfers may be safely relaxed only with the progress of political integration, which at this stage must be expected to be very slow. As for the monetary union, there is also the need to reform the TARGET instrument, possibly along the U.S. model, and to integrate more fully the national central banks with the ECB in the conduct of common monetary, credit, and liquidity policy.
AGATA GOSTYŃSKA

The Fiscal Compact
and European Union Economic Governance:
An Institutional and Legal Assessment

Introductory Remarks

The Greek sovereign debt crisis has questioned the foundations of the Economic and Monetary Union (EMU) and confronted the Member States with the question of whether a eurozone member should be allowed to fail.1 The potential risks and costs of further eurozone destabilisation or a break-up has influenced wide European Union actions that aim to maintain the financial stability of the eurozone. The vision of a crisis contaminating other EU economies has affected work on strengthening the economic arm of the EMU, including surveillance of Member States’ fiscal policies in order to avoid similar dilemmas in the future.2

The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (“fiscal compact”) constitutes one of the latest EU efforts to introduce stricter fiscal discipline in the eurozone.3 It was agreed on 30 January 2012, and signed on 2 March 2012, by 25 Member States, except for the United Kingdom and Czech Republic.4 This article will mainly focus on the legal and institutional aspects of the fiscal compact and its relationship with EU law. However, it seems essential to present the current economic architecture in order


2 This article reflects the state of EU actions undertaken between May 2010 and April 2012. At the time of writing this article, ratification of the fiscal compact had started in the signatory Member States but was uncertain whether and when it would enter into force.


4 While the United Kingdom did not intend to conclude the fiscal compact from early on, the Czech Republic participated in the negotiations with the intention to sign the text but eventually refused to accept the rules envisaged by the fiscal compact.
to point out the interdependence of the specific measures established and implemented since the Greek sovereign debt crisis erupted. This will show what role, if any, the fiscal compact plays in the architecture of EU economic governance. While it is impossible to describe the whole package of reforms introduced since May 2010, it is vital to mention the six legislative measures aimed at strengthening EU economic governance (“six pack”)\(^5\) and the permanent European Stability Mechanism (ESM),\(^6\) which is meant to replace temporary rescue mechanisms such as the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM).\(^7\) The provisions of the fiscal compact are directly linked to those mechanisms. The fiscal compact introduces among its contracting parties stricter surveillance that, to a large extent, has already been covered by “six pack” legislation. It is also worth noting that the financial support from the ESM that is supposed to start operating from July 2012 might be granted only if the potential recipient has ratified the fiscal compact and transposed the balanced budget rule into its national legal order.

\section*{An Asymmetrical Structure}

The world financial crisis, followed by a sovereign debt crisis in some of the eurozone Member States, has fully exposed the weak construction of the EMU. The Lisbon Treaty, which entered into force on 1 December 2009, has not

\footnote{On 29 September 2010 the European Commission issued six legislative proposals concerning the amendments of the preventive and corrective arms of the Stability and Growth Pact, effective enforcement of the budgetary surveillance in the Eurozone, prevention and correction of the macroeconomic imbalances as well as requirements for budgetary frameworks of the Member States. Adopted package of five regulations and one directive entered into force on 13 December 2011. The “six-pack” was facilitated by the proposal of 23 November 2011 for a regulation by the European Parliament and Council for common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficits of Member States in the euro area (COM(2011) 821 final 2011/0386 (COD), and also by a proposal for a regulation by the European Parliament and Council to strengthen economic and budgetary surveillance of Member States in the euro area that were experiencing or threatened with serious difficulties with respect to their financial stability (COM(2011)819 final 2011/0385 (COD). The proposals are jointly referred to as the “two-pack.” At the time of writing this article, the negotiations between the Council and the European Parliament were still ongoing.}

\footnote{Treaty Establishing the European Stability Mechanism, www.european-council.europa.eu.}

\footnote{On 30 March 2012 the Eurogroup finance ministers decided to increase the firewall of the financial assistance. The EFSF will temporarily remain active in financing programmes that already started and until mid of 2013 it may be also involved in the new programmes. See: Statement of the Eurogroup, 30 March 2012, www.consilium.europa.eu.}
introduced any far-reaching changes regarding its functioning, either.\textsuperscript{8} It maintained the EMU’s asymmetrical shape as established by the Maastricht Treaty. While monetary policy in relation to Member States whose currency is euro belongs to the EU’s exclusive competences, decisions about economic policy are still taken at the Member State level and only coordinated by the EU. Additionally, EU Member States evaded the rules envisaged by the Stability and Growth Pact adopted in 1997, which supplements treaty rules about the excessive deficit procedure, and eventually diluted them in 2005.\textsuperscript{9}

EMU also did not provide any solidarity mechanism that would be at hand for the EU to activate financial support for a eurozone member in need.\textsuperscript{10} On the contrary, the Lisbon Treaty maintained the “no-bailout clause” in Art. 125 of the Treaty on the Functioning of the European Union (TFEU), stating that both the EU and its Member States should not be liable or assume the commitments of any other Member State.\textsuperscript{11}


\textsuperscript{11} See Art. 125 TFEU: “The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any member state, without prejudice to mutual financial guarantees for the joint execution of a specific project. A member state shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another member state, without prejudice to mutual financial guarantees for the joint execution of a specific project.” Interestingly, the no-bailout clause applies to the eurozone, while article 143 TFUE provides application of the solidarity mechanism to member states with the euro derogation (“mutual assistance”). See: Treaty on the Functioning of the European Union, OJ EU C 83/47, 30 March 2010 and D. Sobczyński, “Ramy prawne tzw. mechanizmu greckiego oraz Europejskiego Mechanizmu Stabilności,” Europejski Przegląd Sądowy, February 2012, p. 27.
Greek Sovereign Debt Crisis: Impetus for Strengthening EU Economic Governance

Awareness of the potential consequences of the Greek debt crisis being ladled out to other euro area members influenced the activities of EU political leaders in 2010. Establishing a proper firewall by using available EU treaty tools became the main challenge for EU decision makers. On 23 April 2010, Greece issued a formal request for financial assistance from the EU, as well as from the International Monetary Fund.12

Temporary rescue mechanisms. The granting of the first Greek rescue package in May 2010 was accompanied by a wide debate around the weak points of the legal and institutional framework of EU economic governance. Both the bilateral loans granted to Greece, as well as the EFSF and EFSM temporary rescue mechanisms established in May 2010, were taken under legal scrutiny.13 Art. 125 TFEU as well as Art. 122.2 TFEU, which was eventually chosen as the legal basis for the EFSM, caused a “serious headache” for lawyers and political leaders. A reading of Art. 125 TFEU raised doubts about the legality of granting financial assistance to eurozone members. According to the European Central Bank (ECB), however, the stability mechanism only acts as a “liquidity bridge” to facilitate a eurozone Member State’s efforts to reinstate fiscal sustainability, and as such does not seem to violate the non-bailout clause.14

Art. 122.2 TFEU envisages that financial assistance can be granted to a Member State if it is in difficulties or seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its

It is doubtful, however, whether a sovereign debt crisis in Greece may be used as a reason for an event beyond a Member State’s control.\(^ {15}\)

**Permanent European Stability Mechanism.** Threatened by potential concerns, or even legal challenges that could be raised by national constitutional organs, EU Member State leaders decided to replace the temporary rescue mechanisms with the European Stability Mechanism (ESM), which would operate in a permanent manner.\(^ {17}\) This idea was particularly exhorted by German Chancellor Angela Merkel. She and French President Nikolas Sarkozy on 18 October 2010 issued a declaration in Deauville calling for the establishment of the ESM and the amendment of the EU treaties.\(^ {18}\) Amendment of the treaties which, just one year after the Lisbon Treaty entered into force, was resisted by some EU Member States.\(^ {19}\) However, thanks to the application of a simplified revision procedure envisaged in Art. 48.6 of the Treaty on the European Union (TEU), Member States were able to avoid a time-consuming treaty revision process that would threaten to open a Pandora’s box.\(^ {20}\) The European Council adopted at its meeting on 25 March 2011 a decision to amend Article 136 TFEU with Paragraph 3,

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\(^{15}\) See Art. 122.2 TFEU: “Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned. The President of the Council shall inform the European Parliament of the decision taken”. See: *Treaty on the Functioning of the European Union*, OJ EU C 83/47, 30 March 2010.


\(^{19}\) P. Spiegel, Q. Peel, “Treaty Change Forced on to EU’s Agenda,” *The Financial Times*, 27 October 2010.

\(^{20}\) After the art. 136 TFUE was chosen to be amended in order to serve as a legal basis for the ESM, it became clear that a simplified revision procedure could be applied. The conditions required by the simplified revision procedure were met: the art. 136 TFEU is envisaged in the part III of the Treaty and does not increase the competences conferred on the Union in the treaties. After the European Parliament and the European Central Bank delivered obligatory in the process opinions, the European Council could adopt a respective decision. See: art. 48.6 of the *Treaty on the European Union*, OJ EU C 83/42, 30 March 2010.
establishing the foundations for the future operation of a permanent stability mechanism.\textsuperscript{21}

The ESM will operate on the basis of an international agreement that was concluded between the eurozone Member States and signed in February 2012.\textsuperscript{22} It will enter into force once it is ratified by its signatories, representing not less than 90\% subscriptions to the ESM in accordance with the contribution key set out in the annex to the treaty.\textsuperscript{23} According to a political commitment, the ESM treaty should enter into force in July 2012. Any delay in the EU treaties’ revision probably would not affect the operation of the ESM, which is governed by the international public law. However, the operation of the ESM without any reference in the EU treaties could be seen as an attempt to omit the no bail-out clause in Article 125 TFEU, or at least a violation of the loyal cooperation rule.\textsuperscript{24}

\textbf{“Six pack.”} The discussion about the establishment of the ESM coincided with work on the “six pack.” On 15 March 2011, the Council of the European Union agreed a general approach towards the European Commission’s (EC) legislative proposals and, led by the Hungarian presidency, subsequently opened tough legislative negotiations with the EP. The “six pack” was agreed on 4 October by EU finance ministers and adopted on 8 November. The reforms envisaged in the six legislative acts are the most complex measures on EU economic governance since the EMU was established. They strengthen the provisions of the Stability and Growth Pact, both in the scope of preventive and corrective arm of the Pact. The possibility to apply semi-automatic sanctions by introducing the reversed qualified majority voting in the EU Council (a recommendation or proposal by the EC is considered adopted unless a qualified majority of Member States vote to oppose it) is one of the greatest achievements of the “six pack” and enhances the position of the EC in enforcing the provisions

\textsuperscript{21} The art. 136 TFEU was amended by adding paragraph 3 stating: “The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality,”. See: European Council Decision no 2011/199/E of 25 March 2011 Amending Article 136 of the Treaty on the Functioning of the European Union with Regard to a Stability Mechanism for Member States Whose Currency is the Euro, OJ. EU L 91/1, 6 April 2011.


\textsuperscript{23} Ibidem. See: Article 48 and an annex.

of the Stability and Growth Pact. Additionally, the new rules foresee a mechanism not only for monitoring macroeconomic imbalances but also for imposing sanctions on those Member States that have excessive macroeconomic imbalances.25

**Fiscal compact: fostering fiscal discipline?** Shortly after adopting the “six pack”, a debate about new fiscal discipline arrangements arose. It was led by Germany and France, which were pushing for a new political framework for eurozone integration. Failing to secure Great Britain’s acceptance of a new treaty change to introduce stricter fiscal discipline, the heads of state or government at a European Council meeting on 8–9 December 2011 decided to take an intergovernmental path to establishing foundations for stricter EU fiscal surveillance. The fiscal compact was negotiated between December and January 2012. It was approved on 30 January 2012, and signed on 2 March 2012. It will enter into force on 1 January 2013 once it is ratified by 12 of the 17 euro area Member States. Non-euro area EU Member States that have signed the treaty may voluntarily decide to abide by all the provisions of the fiscal compact, particularly with Title III. There is, however, no such obligation envisaged in the text.26 The fiscal compact aims to maintain sustainable public finances and prevent eurozone Member State deficits from being excessive (Title III), better coordinate the economic policies of the signatories (Title IV), and institutionalise the decision-making process within the eurozone by, for example, formalising the Euro Summits.27 Its primary goal was to introduce stricter fiscal discipline in the eurozone. Therefore, it aims to ensure convergence of a given Member State’s medium-term objective (MTO) with a limit on structural deficit at 0.5% GDP at market prices and at 1% GDP for Member States whose ratio of government debt to GDP is significantly below 60% and where risks to the long-term sustainability of public finances are low. It also obliges any signatory from the eurozone to reduce public debt at an average annual rate of one-twentieth when its debt level exceeds 60% annual GDP. It also introduces an obligation to transpose the balanced budget rule to the

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national legal orders, preferably at the constitutional level. It should be noted that activation of the ESM fund will depend not only on the compact’s ratification but also on the effective transposition of the balanced budget rule.

Most of the instruments proposed by the fiscal compact are already present in currently binding EU secondary law. Probably, one of the few innovations brought in by the fiscal compact is the obligation to transpose the balanced budget rule to the national legal orders, and setting the jurisdiction under the Court of Justice of the European Union (CJEU). Moreover, the fiscal compact does not provide any new instruments to generate growth in an EU bothered by a mild recession. The fiscal compact could be read as rather a political signal to those Member States whose societies contribute the most to the rescue mechanisms as it requires Member States to maintain more credibility and long-term commitments during the eurozone debt crisis. It also has been pointed out that EU secondary law can be easily watered down by further amendments, while any changes to the international agreement require the consent of all its contracting parties. The question that remains open, no matter the legal basis for the fiscal discipline’s instruments, is whether the Member States will apply them strictly. The example of Spain, which announced shortly after having signed the fiscal compact that it would miss its deficit target, might be the first test of EU commitment to the new measures.

**Fiscal Compact: a Legal and Institutional Assessment**

The provisions of the fiscal compact raise some political and legal doubts. They concern, among other questions, the international character of the treaty and its impact on European integration, EU institutional involvement in this intergovernmental form of cooperation and new governance of the eurozone. The fiscal compact is given as an example of the further fragmentation of

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European integration and a facilitator of a two-speed, or avant-garde Europe because it offers a differentiated pace of integration for EU Member States. These concerns might occur in the national debates accompanying the fiscal compact’s ratification process. The fact that the provisions of the fiscal compact had been modified at least six times before it was finally signed only proves its controversial content.32

A decision to take the intergovernmental path to further integrate is not a first in the history of European integration. In 1985, the Benelux countries, France, and Germany signed the Schengen Agreement, which was subsequently joined by other Community members. Similarly, in 2005, the Benelux countries, Germany, Spain, France, and Austria concluded a convention outside the EU treaty framework on stepping up cross-border cooperation, particularly in combating terrorism, cross-border crime, and illegal migration (Prüm Convention).33 However, both the Schengen acquis and Prüm Convention were later incorporated into the legal framework of the EU. Finally, the Treaty establishing the European Stability Mechanism concluded by the eurozone members on 2 February 2012 also includes an intergovernmental form of cooperation. EU Member States are free to enter into other international agreements. However, the rules they establish should not violate the rights of EU members that are not party to such an agreement and should not conflict with EU norms. It results from the supremacy of EU law over international agreements concluded by some of the EU Member States.34 Similarly, if contracting parties plan to make use of EU institutions beyond the competences assigned to them by the treaties, the consent of all EU Member States seems to be required.35 This argument was initially

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33 Convention between the Kingdom of Belgium, the Federal Republic of Germany, the Kingdom of Spain, the French Republic, the Grand Duchy of Luxembourg, the Kingdom of the Netherlands and the Republic of Austria on the stepping up of cross-border cooperation, particularly in combating terrorism, cross-border crime and illegal migration, http://register.consilium.europa.eu.


raised by the British prime minister, who feared the empowerment of the EC or the CJEU beyond the EU treaties, and thus beyond the control of all the Member States. Those concerns were eventually dropped after the UK was given observer status in the negotiations.\(^{36}\) Additionally, questioning the legitimacy of the fiscal compact could lead to further marginalisation of the UK on the EU scene after having vetoed treaties’ changes.

Negotiations on the fiscal compact were led by a working group comprised of three representatives from each of the 26 Member States, the EC, and the EP. The representatives of the British delegation participated in the negotiations with observer status, as did the EU institutions. Admitting the British, the EC, and the EP to the negotiation table was supposed to limit the voice of criticism coming mainly from MEPs.\(^{37}\) The deputies who had been simply passed over in the decision-making process concerning the fiscal compact questioned its conformity with EU treaties.

Establishing the foundations for strengthened fiscal cooperation outside the EU framework and addressing those rules mainly to eurozone members was perceived as unfavourable for non-euro Member States. Although the influence of the non-euro Member States on the Eurogroup’s decision-making process was already marginal, a new form of cooperation outside the EU treaties could potentially lead to a further shift of the Eurozone from the rest of the EU. Therefore, the goal of the non-euro Member States participating in the negotiations, and supported by the EU institutions, was to keep the provisions of the fiscal compact as compatible with EU law as possible.\(^{38}\)

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\(^{38}\) See the Statement of the José Manuel Durão Barroso, President of the European Commission in which he warns that the parallel structures would lead to divisions jeopardising the EU and single market. J. M. D. Barroso, Statement by President Barroso on the International Agreement, European Parliament, Strasbourg, 18 January 2012, www.europa.eu.
**Consistency with EU Law.** A comparison of the subsequent, leaked versions of the fiscal compact revealed a dynamic negotiation process in which not only the provisions but also the title had been modified many times. While initially the contracting parties were intending to introduce a reinforced economic union, over the course of the negotiations this was replaced with a title, “Treaty on the Stability, Coordination and Governance in the Economic and Monetary Union,” which clearly refers to the EU policy envisaged in its primary law.

The final version of the fiscal compact signed on 2 March 2012 contains a separate section—“consistency and relationship with the law of the Union.” It is envisaged that the treaty will be applied and interpreted in conformity with the EU treaties, in particular with the rule of loyal cooperation and with EU law (Art. 2 of the fiscal compact). The provisions of the fiscal compact should not encroach on EU competences concerning the economic arm of the EMU, either.

One of the postulates raised during the negotiations and aimed to narrow the framework of the fiscal compact with EU law was the application of a sunset clause. MEPs called for the incorporation of the compact’s provisions into the EU legal order within five years or it would become obsolete after seven years. However, the introduction of a sunset clause also poses a risk that contracting parties may prolong international agreement instead of bringing it under the EU legal framework before the time lapses. In the final version of the fiscal compact, an intention to incorporate its substance into the EU primary law within five years of the treaty’s coming into force was expressed (Art. 16 of the fiscal compact).

The fiscal compact also refers to the enhanced cooperation provided in Article 20 TEU and 326–334 TFEU. It might be applied to: “… matters that are essential for the proper functioning of the euro area, without undermining the internal market (…)” (Art. 10 of the fiscal compact). It needs to be underlined, however, that according to the EU treaties, enhanced cooperation can be initiated only for non-exclusive EU competences. It cannot undermine the internal market or economic, social, or territorial cohesion and should not create barriers to trade or affect competition between EU Member States. Although Article 10 of the fiscal compact does not enumerate all the conditions necessary for initiating this

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cooperation, it should be kept in mind that any actions undertaken within the framework of the fiscal compact should not violate EU treaties.

What raises probably the biggest question mark over the fiscal compact is a possible conferral of new competences to the EC and CJEU outside the EU treaties framework. Even if it is decided that no legal difficulty is caused by these provisions, it could still be argued whether it is legitimate to use existing institutional competences in a separate architecture.40

**The role of the European Commission.** The role of the European Commission has already been strengthened in the “six pack.” By introducing reversed-qualified-majority voting on the European Commission’s recommendations or proposals to impose sanctions in the preventive and corrective arms of the Stability and Growth Pact, enforcement of the fiscal discipline was upgraded.41 Similarly, the EC was also given the particular competence of monitoring and correcting macroeconomic imbalances. According to the new legislative pieces, the EC operates an alert mechanism that aims to identify those Member States where macroeconomic imbalances exists.42 On the basis of an alert mechanism report, the EC may identify Member States where more in-depth analysis is required. After having concluded a specific Member State review, the EC may recommend opening an excessive imbalance procedure. Its recommendation is deemed adopted unless a qualified majority of the Council oppose this step.


41 In case the euro area Member State has not reached its medium term budgetary objective the preventive arm of the Stability and Growth Pact provides sanctions in the form of self-interest deposit in the amount 0.2 % GDP. The corrective arm of the Pact provides sanctions in the form of non-interest bearing deposit in the amount of 0.2 % GDP once a Member State is taken under the excessive deficit procedure. It can be however converted into the fine of 0.2% GDP if the recommendations for correcting the excessive deficit procedure have not been followed. See: Regulation 1173/2011 of the European Parliament and Council of 16 November 2011 on the effective enforcement of the budgetary surveillance in the euro area, OJ EU L 306, 23 November 2011, pp. 1–7.

The fiscal compact seems to facilitate the provisions of the Stability and Growth Pact. Contracting parties whose currency is the euro will commit to supporting the EC’s proposals or recommendations to open an excessive deficit procedure unless a qualified majority of them, minus the Member State concerned, oppose it (Art. 7 of the fiscal compact). The reading of this provision may give an impression that the parties are trying to circumvent the voting rules required in Article 126.13 TFEU by establishing reversed qualified majority voting. While the reversed qualified majority voting is already provided in the “six pack,” it is still a secondary EU law. Its provisions should therefore be rather treated as specifying and complementing rules established by primary law. However, according to written evidence prepared for the European Scrutiny Committee in the British House of Commons, the coordination of the way the votes are cast in the Council could also be perceived as part of establishing voting coalitions that are not excluded by the treaties and which are often exercised within the Council.43

The European Commission also has been empowered to monitor the implementation process of the balanced budget rule into national legal orders. The EC has been invited to present a report on the transposition process. In case a contracting party has not introduced provisions of Article 3.2 of the fiscal compact into its binding law, or in case the EC does not find observations of the party satisfactory, the EC will point out in its report that the party failed to comply with the fiscal compact’s rules (Art. 8 of the fiscal compact). If this is the case, a Member State that fails to comply with Art. 3.2 should be referred to the CJEU. Interestingly, in one version of the fiscal compact discussed during the negotiations, the Commission was authorised, along with the contracting parties, to bring the action to the CJEU. Moreover, such an action would cover not only charges for failing to transpose the rules into the national legal order on time but also for breaching the whole of Title III.44 Establishing a special infringement procedure and providing the Commission with the prerogative to bring the case to the CJEU would probably require an amendment to the EU treaties, and as

43 Reinforcing the Eurozone, written evidence from Professor Michael Dougan and Dr Michael Gordon, Liverpool Law School, University of Liverpool, European Scrutiny Committee, House of Commons, 13 January 2012, www.publications.parliament.uk.

such was abandoned by the contracting parties.\textsuperscript{45} Additionally, the provisions of the early draft could also be considered as circumventing Article 126.10 TFEU that excludes application of the infringement procedure provided in the Article 258-259 TFEU to the Article 126.1-9 TFEU.

The role of the Court of Justice of the European Union. The Court of Justice of the European Union was given jurisdiction in the fiscal compact on the basis of Article 273 TFEU.\textsuperscript{46} It constitutes the legal basis for settling disputes arising from the application of international agreements concluded between the Member States.

Article 273 TFEU can be applied if an international agreement concerns matters regulated by EU treaties. It seems that this condition can be interpreted broadly, and thus disputes affecting only part of EU law can be brought to the CJEU.\textsuperscript{47} The scope of the CJEU’s jurisdiction depends on the special agreement between the contracting parties.\textsuperscript{48}

As previously noted, the fiscal compact authorises the CJEU to decide whether a contracting party has failed to transpose the balanced budget rule to its national legal order (Art. 8 of the fiscal compact). This provision should be treated as a special agreement between the contracting parties, as envisaged in Article 273 TFEU. In accordance with the fiscal compact, the case may be brought to the CJEU only by a contracting party (or parties). They may base their actions on a report previously drafted by the Commission or independently of the European Commission’s activity. Once a concerned party fails to comply with the judgment of the court, the contracting party (or parties) may request the


\textsuperscript{46} In accordance with the article 273 TFEU: “The Court of Justice shall have jurisdiction in any dispute between Member States which relates to the subject matter of the Treaties if the dispute is submitted to it under a special agreement between the parties”, Treaty on the Functioning of the European Union, OJ. EU, C 83/47, 30 March 2010.


imposition of financial sanctions, as envisaged in Article 260 TFEU.\(^{49}\) Noncompliance with a previous verdict of the court, may be fined with a lump sum or a penalty payment not exceeding 0.1 of its GDP (Art. 8.2 of the fiscal compact).

In Article 8 of the fiscal compact, most of the conditions for the resolution clause to be viable are met. However, it can be questionable whether imposing financial penalties on the contracting party or parties by the Court, as provided for in Article 260 TFEU, is covered by Article 273 TFEU. Some reservations can be raised if this (imposition of financial penalties) is taken as a separate competence from the dispute resolution envisaged in Article 273 TFEU.\(^{50}\)

It should be noted that it is not a new practice to grant CJEU jurisdiction over disputes that may arise from international agreements concluded by the EU Member States.\(^{51}\) The most recent example of the establishment of a dispute settlement clause in accordance with Article 273 TFEU was the Treaty establishing the European Stability Mechanism.\(^{52}\)

The financial sanctions imposed on a contracting party whose currency is the euro will be given to the ESM. The penalty paid by a non-eurozone contracting party that has decided to bind itself to Part III of the fiscal compact will be given to the general budget of the European Union.\(^{53}\)

**New competences for the EU presidency trios.** The contracting parties agreed to annex the additional arrangements in which they specified a procedure for referring a case to the CJEU to the minutes of the signing of the fiscal compact.\(^{54}\) They committed themselves to support the EC in case the balanced

\(^{49}\) See: Article 260 of the *Treaty on the Functioning of the European Union*.

\(^{50}\) According to Professor Pernice empowering the CJEU with the competence to impose fines would require a formal EU treaties amendment, see: *International Agreement on a Reinforced Economic Union, op. cit.*, p. 24.

\(^{51}\) Interestingly, no case has been referred to the CJEU on this basis yet. See: K.P.E. Lasok QC, T. Millett, assisted by A. Howards, “The Court of Justice…,” *op. cit*.

\(^{52}\) See Article 37 of the *Treaty Establishing the European Stability Mechanism*, www.european-council.europa.eu, on interpretation and dispute settlement.

\(^{53}\) That was one of the condition raised by the Danish delegation which is willing to bind itself with the fiscal compact’s requirements pointed in title III. See: V. Pop, “No Consensus on Sanctions under Fiscal Pact, Says Denmark,” *EU Observer*, 23 January 2012.

\(^{54}\) *Arrangements agreed by the Contracting Parties at the time of Signature concerning Article 8 of the Treaty annexed to the Minutes of the signing of the Treaty on the Stability, Coordination and Governance in the Economic and Monetary Union*, www.msz.gov.pl.
budget rule is not properly transposed. The request should be brought to the Court within three months of the publication of a report showing non-compliance with Article 3.2 of the fiscal compact. The arrangements, although of a non-binding character, strengthen the role of the Commission and, interestingly, acquire a new competence for the trio presidency in EU economic governance. According to these arrangements, the Member States of a trio presidency will jointly refer the case to the CJEU. However, this applies only to rotating presidencies that are: bound by Article 3 and 8 of the fiscal compact, not in breach of obligations arising out of Article 3.2, not under a procedure envisaged in Article 8 of the fiscal compact and unable to act on other justifiable grounds in accordance with international rules. If no contracting party of the trio holding the presidency meets those conditions, the obligation to act will lie in the hands of the preceding trio presidency.\(^55\)

Involving the trio presidency in enforcing fiscal discipline was aimed at increasing the credibility and transparency of those actions. A trio presidency that is composed of both euro and non-euro, as well as big and small Member States is less exposed to accusations of acting according to individual interest.

**New eurozone governance: a split into a multi-speed Europe?** The fiscal compact formalises the Euro Summits of the heads of state or government of the eurozone. So far, only Eurogroup meetings, comprising eurozone finance ministers, have been institutionalised in the Lisbon Treaty.\(^56\) It should be noted, however, that the eurozone summits have already been organised in the past.\(^57\)

According to the provisions of the fiscal compact, eurozone Member States will meet at Euro Summits at least twice a year to discuss issues related to the Economic and Monetary Union (Art. 12 of the fiscal compact). Those meetings will be chaired by the President of the European Council, who was chosen to serve this post during the European Council meeting on 1 March 2012. It also will be attended by the president of the European Commission while the presidents of the European Central Bank, European Parliament and Eurogroup may be invited to join the meeting.

\(^55\) *Ibidem.*


\(^57\) Two Eurozone summits were organised in 2010 while in 2011 four. They were chaired by the President of the European Council.
The initial versions of the fiscal compact excluded non-euro contracting parties from participating in the Euro Summits. This proved to be unacceptable for Poland and others, and who threatened not to join the compact if their presence at the summits was rejected.58 The final version concluded by the 25 Member States reflects some of the non-eurozone members’ expectations. It envisages the participation of non-eurozone members in Euro Summits on condition that the summits concern issues of competitiveness, global architecture of the euro area, or the implementation of the fiscal compact. Interestingly, the provisions about the governance of the euro area should apply to all eurozone contracting parties irrespective of whether their national ratification procedures are completed or are ongoing. Non-euro Member States will be allowed to participate in the Euro Summits once they ratify the fiscal compact (Art. 14 of the fiscal compact). Favourably for non-euro states, it was agreed that the Euro Summits would take place after the European Council convenes. This slightly weakens the perspective to dominate the European Council’s agenda by a so-called eurozone coalition. However, because the preparation and follow-up of the summits will be in the hands of the Eurogroup, whose meetings are for euro members only, it remains uncertain what will be the real influence of the non-euro states on the meeting’s agenda. The first years of the fiscal compact’s implementation might turn out to be vital for non-eurozone states, who should not only request information about the meeting’s agenda but also ask to be included in discussions devoted to the programme of the meeting.

The role for the European Parliament and national parliaments. The European Parliament has not been given any particular role in strengthening fiscal discipline in the fiscal compact. A delegation comprising MEP’s Elmar Brok, Roberto Gualtieri and Guy Verhofstadt participated in the negotiations only with observer status and did not manage to influence the final provisions much. The final text of the fiscal compact reflects the marginal role of the EP. The president of the Euro Summit will present a report to the EP after each of its meetings, while the president of the EP may only be invited to the summit to speak (Art. 12.5 of the fiscal compact). The reading of this provision shows that the EP’s role in the fiscal discipline set up by the fiscal compact will mostly lie in the hands of the president of the European Council, at present Herman Van Rompuy, who will chair the Euro Summit meetings. It should also be noted that

similar to the rules on convening a European Council meeting, even though invited, the EP president probably would have to leave the meeting after giving the speech. Even though the EP has not won many concessions in the negotiation process it supported non-eurozone Member States. The EP, which strongly defends the community method as a major tool for further EU integration, expressed a preference for opening the Euro Summits to non-eurozone Member States and the fiscal compact’s closer relationship with EU law and its incorporation into EU treaties.

Contrary to the weak position of the EP in the fiscal compact negotiations, a significance of national parliaments can be observed in the final text. The fiscal compact establishes a parliamentary discussion platform for budgetary issues through a conference of representatives of the relevant committees of the EP and national parliaments (Art. 13 of the fiscal compact). By supporting inter-parliamentary debate on EMU-related matters, the fiscal compact aims to facilitate a fast ratification process in which national parliaments will have the final say.

Conclusions

The decision to undertake an intergovernmental path to further integration of the economic arm of the EMU has opened a discussion about the future of the common European project. The fiscal compact, particularly its ratification rules and governance of the eurozone, has threatened further divisions not only between euro area members and the rest of the EU but also within the eurozone itself.

Differentiation within the EU is nothing new. Instruments such as enhanced cooperation or opt-outs provided in the EU treaties offer a possibility to proceed in certain areas when others hesitate, normally delaying the integration processes. However, these instruments were part of or, as with the Schengen or Prüm agreements, were incorporated into the EU acquis communautaire. The fiscal compact and the ESM treaty are projected to function on the basis of international agreement, and as such might be perceived as an attempt to create a framework for future, deeper cooperation among the “avant-garde” and not necessarily under the umbrella of EU law. Establishing such legal foundations

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59 In his recent publication Jean Claude Piris describes a further integration within the temporary avant-garde group of Member States as one of the solutions for coming out from the political and decision making stagnation of the EU 27. See: J.C. Piris, The Future of Europe: Towards a Two-Speed EU?, Cambridge University Press, Cambridge, 2012.
for a core European club with some peripheries available to others threatens the community method and raises questions about the future relationship between both legal systems.\textsuperscript{60} Leaving aside the question of the role of a two-speed Europe in fighting the EU crisis, it is more than certain that the selective application of EU rules and bypassing common EU institutions might lead to further political stagnation of the EU. In order to avoid this scenario, the non-eurozone members that signed this treaty should use the opportunity to guard EU coherence and the community approach within the fiscal compact’s framework. Even though they might not always have a say at the Euro Summit table, it should be remembered that no substantial changes to the content of the fiscal compact, including ones that could threaten EU integrity, can be made without the consent of all contracting parties.\textsuperscript{61}


\textsuperscript{61} See: M. Szpunar, “Czym jest Traktat Fiskalny,” Gazeta Wyborcza, 5 April 2012.
Negotiations on the New EU Financial Framework 2014–2020: Theory, Realpolitik and the Polish Perspective

Introduction

Negotiations of funding periods in the European Union (EU) are characterised by a constant cycle, repeating every seven years. Although the EU general budget covers only about 1% of Gross National Income (GNI) across the EU, its size, revenue structure, and expenditures produce great tension and attract much public opinion in Member States. Individual governments are trying at all costs to defend their net position, which forms a deadlock, preventing any more rational discussion about reform of EU finances.

The current context of the negotiations is far more difficult than the previous one. The crisis in the euro area not only brought austerity pressure, but also contributed to the weakening of EU institutions and strengthening of the intergovernmental factor. It does not create a good climate for talks on common interests. Therefore, negotiations on the new EU Multiannual Financial Framework 2014–2020 (MFF) are likely to lean towards a rotten compromise, with the core question concerning the sacred net positions, accompanied by disputes concerning the total size and amount of own resources along with a dogfight amongst Member States concerning agriculture and cohesion policies. One of the most active countries in the negotiations will be Poland, currently the largest net beneficiary, which will try to gather around itself a coalition of other countries. Nevertheless, the difficult context of the negotiations will require that Poland place itself in a defensive position.

In the first section of the article, the authors conduct a general literature review concerning questions strictly linked to the EU budget, such as the functions of common finances, key spending areas or the sizes of EU finances. The second part concerns the course of the EU Multiannual Financial Framework negotiations and broadly describes the Commission’s proposal, which became the base for negotiations. In the third section, the authors show the key coalitions of interest and the negotiations process, including the interactions between the Member States and EU institutions. The fourth section contains original own-estimations showing that the Commission’s proposal is the most advantageous
solution for Poland, and explaining why the net payers’ claims on specific items only worsen Poland’s balance towards the EU budget.

**Finances and European Integration**

The development of the EU’s finances is inextricably linked with the history of European integration, and the various stages correspond to a gradual strengthening of cooperation between European countries. Brigid Laffan, in her fundamental book on EU finances, listed the major factors that have contributed to the development of community budgets. She claimed that the creation of common policies, growth in independence of institutions, search for stability in the budgetary process, and successive enlargements were the major driving forces of development of EU finances. This illustrates well that the development of the own system of finances was one of the most important processes since the beginning of European integration. The present stagnation in the discussions about the EU’s budget can be interpreted as one of the symptoms of a crisis of European integration in general.

Alongside successive budgetary battles between Member States with increasing participation of the institutions, numerous researchers have been examining these problems from a theoretical angle. They have tried to explain the optimal shape for EC/EU finances using the theory of fiscal federalism developed by Wallace E. Oates, which concerned the most effective assignment of fiscal competences to various levels of public authority. Fiscal federalism was developed on the example of existing federations, especially the United States, which does not fully correspond to the complex, hybrid structure of the European Union. Nevertheless it gave some insight into how classical functions of public finance should be optimally positioned. Allocative and redistributive functions should be located as close to citizens as possible, while stabilisation occurs at a central level. Yet, the EU budget cannot fulfil the role of stabilisation as it is simply too small and insignificant compared to the overall EU economy. The stabilisation function was taken over by the hybrid instruments: European Financial Stability Facility (EFSF) and the new European Stability Mechanism (ESM), which are based on intergovernmental cooperation. If we add the planned borrowing capacities of these instruments, set at €700 billion, to the

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current Eurosystem’s balance sheet, which is about €3 trillion, the real amount of MFF payments ceases to impress.³

The McDougall Report suggested increasing the common finances to around 5–7% of the grouping GDP, or even 10% if defence was included.⁴ As Iain Begg rightly noted, this report concerned a community of 15 members and was characterised by much smaller differences in economic development than at present.⁵ The conclusions from the McDougall Report today represent a kind of “political fiction” when compared to the current battle to keep the EU spending level at 1% of GDP. It also gives the impression of crisis thinking, when politicians from net beneficiary countries react in an allergic way even to proposals to maintain the current level of payments from the EU general budget.

The attempts were also made to identify the possible shape of the budget using the concept of European added value (EAV). Although vague and unclear, this concept is frequently present in discussions about the EU and in European Commission (EC) documents. In the EU budget review, it is described as one of five core principles.⁶ The last Commission proposal concerning the new MFF issued on 29 June was accompanied by a study titled “The Added Value of the EU budget” where the principle was justified in the following way:

“The European dimension can maximise the efficiency of Member States’ finances and help to reduce total expenditure, by pooling common services and resources to benefit from economies of scale. As a consequence, the EU budget should be used to finance EU public goods, actions that Member States and regions cannot finance themselves, or where it can secure better results.”⁷

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³ Authors’ own estimates.
In this definition there is an emphasis on the effect of economies of a scale, that is, to bring more added value from every euro spent at the EU level than at the national level. So, practically the idea is grounded in the subsidiarity principle, one of the political and legal fundamentals of the EU.

The EAV concept is frequently underestimated and slighted by those who align with realpolitik, as some rightly point out, it is “good in theory but difficult to use in practice.”8 Yet, it seems to be the most useful tool in justifying which expenses should be a part of the common system of finances in order to make it the most effective from an economic point of view. One of the most interesting analyses of European added value was the one of Daniel Tarschys, who examined it in three sample fields—trans-European networks, research, and cultural policy—admitting that in each of them there is a large margin for discretion in what added value actually is.9 Probably, the search for European added value would be an even more difficult task if the Common Agricultural Policy (CAP) or cohesion were examined.

So, what goals should be supported by EU finances? There is general agreement that the funds should be used for objectives contained in EU growth strategy Europe 2020; however, the problem is that the Member States each understand the objectives differently. To some extent, the answer to this question can be found in some other theoretical works. “Efficiency, Stability and Equity,” also known as the Padoa–Schioppa Report, published in 1987, advocated for limitation of the CAP budget and opted for strong regional policy closely linked with a macroeconomic governance system through conditionality.10 In its report “Stable Money: Sound Finances,” issued in 1993, the Commission did not advocate a significant increase in the EU budget, concluding that a “small budget will do.”11 It underlined the principle of subsidiarity, one of the core principles included in the treaties and supported by the economic rationale of the

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decentralisation of public expenses. Therefore, it puts the burden of proof on those who advocate for increases in supranational finances. Yet, the report states that there are areas in which the disbursement of funds from the transnational level has its justification: environmental protection; infrastructure; research and development; and, to a lesser degree, higher education or external aid.12 The Sapir Report suggested reshaping the EU budget in line with the Lisbon Strategy objectives by creating three funds focusing on growth, convergence and restructuring by concentrating a large part of spending on R&D.13 The report by ECORYS, prepared for the European Commission, concluded that some policies should be shifted to the national level, including direct payments for farms, part of rural development and, surprisingly, competitiveness.14 However, Iain Begg claims that the areas in which spending at the EU level can bring about the greatest added value are in enhancing economic growth, external action, and some aspects of internal security.15

Therefore, theoretical studies based on economic arguments cannot provide a detailed model of EU finances. In fact, opinions on the matter indicate more or less one group—investment in new technologies, enhancing economic growth, promoting structural changes and levelling of differences between regions or other EU-based policies, such as security or external relations.

The lack of a definite answer about what should be in the budget and what should be out, is one of the factors that hinders the budget discussions. However, the shape of the EU budget is determined mainly by political forces, and the economic rationale, even if based on stronger theoretical findings, is in fact dominated by realpolitik.

**The Commission’s Proposals**

The negotiations on the current EU financial perspective (2007–2013) were described by certain politicians as extremely difficult.16 It is therefore impossible to find the right adjective to describe the current talks due to its complexity.

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12 Ibidem.
Apart from the new institutional issues, such as the growing ambition of the European Parliament (EP), and a record number of parties at the negotiating table, the crisis in the euro zone is the most important determinant. As a result, it has not only reinforced the intergovernmental factor or weakened the institutions, but also significantly strengthened the logic of *juste retour*.

Before the European Commission formally launched the negotiations, the Parliament had expressed its opinion on the desired shape of the MFF. The EP stressed several issues that are controversial to some Member States. The most divisive items have not changed since previous negotiations—an increase in the size of the budget by 5%, reform of the own-resources system, high rank of cohesion and innovation policy, evolution of the CAP, and stricter rules and conditions for using common funds. The EP’s position is bold because it neither provides a proposal for negotiations nor is it an honest broker, but it is a regular party to the negotiations that has its own viewpoint on the future of EU.\(^{17}\)

Contrary to the EP, the European Commission had to be much more cautious in preparing a document that would be accepted by Member States as feasible basis for negotiations. That is why it presented a well-balanced proposal in its Communication of 29 June 2011.\(^{18}\) The proposed structure of the next financial perspective does not differ strongly from the shape of the current one. There are also five headings, similar to the existing ones despite new names.

The proposed expenses are strongly connected with the principles of the Europe 2020 strategy. In general it calls for generating strong growth (mainly due to its catalytic character), while also securing the environment. Additionally, the EC claims that only actions with high expected EAV will have the opportunity to be financed through the EU budget. So, it is assumed, that projects should produce not only local but also EU-wide positive effects and should focus on European interests. However, despite the fact that this added value is much more of a concern than in previous periods, it still has not been quantified. Nevertheless, the next financial perspective is expected to be more targeted (the money will be transferred more carefully), than the current one, to meet the demands of the net beneficiaries.

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The overall size of the MFF (counted along with instruments outside the budget) is a little above the level of 1% of EU GNI, hence slightly more than €1 trillion for the entire funding period. Its magnitude is similar to the amount of money that would be spent in the current financial perspective and is a feasible outcome of balancing the constraints and needs of old and new Member States as well as EU institutions. What is more, the size of the next MFF is virtually no larger than the planned size of the budget for 2013 multiplied by seven years and modified by inflation rate. The real size of the budget is greater than that directly shown in the proposal. However one should notice that the Commission presents all EU expenditures, including these inside and outside the MFF. What is more, this amount of money will finance more new EU competences that were the result of the Lisbon Treaty (including the new European External Action Service), thanks to more efficient use of funds. This funding of enlarged areas of priorities and actions will be only possible as innovative financing instruments—based on borrowing and guarantees—will be implemented on a larger scale. Further, the argument for decreasing the budget through a General Affairs Council (GAC) meeting, as called for by several Member States, should not be treated seriously since sector-specific EU councils have generally accepted enlarged funding. Hence, the sum of the agreed enlargement of funding on whole sector-specific projects would hinder the efforts to reduce the overall budget.

Cohesion policy, presented by the Commission as a tool to successfully deliver on the Europe 2020 strategy, is proposed to became a biggest spending item, standing for 37% of budgetary expenses (about €376 billion for 2014–2010), however it is only slightly bigger than heading linked with CAP. Such big and controversial item seems to be risky, as many Member States perceive it as an instrument that donates only poorer Member States. However European Commission wanted to weaken this logic, and proposed modifications of mechanism within this policy in order to enlarge a group of regions covered with this cohesion. The first solution was the introduction of so-called transitional regions, which are more affluent than converging regions but still need support at a regional level. Thanks to this solution, many regions across Europe (for instance, in France) may benefit from cohesion policy, which may encourage France to soften its position concerning CAP. Also, in order to keep funds from accumulating in just several regions, the cap on cohesion policy was
lowered. The cap exists because of the assumption that the regions can only absorb a limited amount of funds. Under the previous formula, the cap had been set at a different level for each country, but in general, the ceiling was about 3.5% of a region’s GNI. Now the ceiling will be unified at 2.5% of GDP for each region, so the funds will be distributed across Europe more equally, which should additionally persuade Member States to accept the budget proposal and treat it as the basis for further negotiations.

The other important issue is the introduction of the sector-specific fund “Connecting Europe.” This will be launched partly (20%) within the cohesion policy funding framework and is focused on transport, energy, and ICT infrastructure. Its considerable size (comprising about 10% of cohesion policy-related instruments) might be a sign of the evolution of funding mechanisms for EU actions towards sector-specific funds at the cost of well-proven horizontal financing solutions. Other possible instruments include an environmental fund, climate change fund, entrepreneurship fund, Small and Medium Enterprises fund and many others, which could eliminate the synergy effect from the concentration of finances on crucial issues of EU interest.

The Common Agricultural Policy is the second biggest spending item in the next financial term. Its size and role, especially direct payments, are often contested. The maintenance of such large expenditures on this policy is explained by the redesign of the policy in order to streamline it with Europe 2020 priorities. The European Commission proposed a more fair and equitable system for support of farms, and thus introduced a slight redistribution of direct payments to countries that receive relatively small amounts of money with virtually no harm to net payers. A certain shuffling of finances is proposed, such as moving funds for food security to the heading “Security and citizenship” and research on food security and the bio-economy to the common strategic framework for research and innovation (not to mention the externalisation of certain amounts for specific action), so that the real budget for CAP will be increased by more than 7%.

22 Ibidem.
With great optimism, the EC proposed priorities for research and innovation issues, such as the continuation of large projects including, for example, the creation of the European Research Council to oversee research in the EU, and the simplification of procedures to achieve adequate funding for research. In order to successfully manage that, the Commission proposed the introduction of a new common strategic framework that would eliminate fragmentation caused by small research programs and would ensure more coherence with other EU policies.23

As for the external dimension, considered by many since the Lisbon Treaty granted new competences to the EU, the needs seem to be limitless, though administrative expenses in the EU budget are under strong pressure to be reduced. The Commission chose a solution that emphasises a mix of funding—EU, national, supranational, regional and private—to meet the EU’s goals in the external dimension, such as the Millennium Development Goals or stimulating good relations with the EU’s neighbours, especially after the Arab Spring. Some instruments, like the European Development Fund, will remain outside the financial framework.

The Commission, in line with the EP’s approach, proposed major reforms to the own-resources system.24 First, it called for the introduction of genuine new own resources that may replace, to some extent, direct national contributions to the EU budget, which now compose 90% of total EU budgetary revenues. This issue is important not only for the EC but also for the EP as it makes the EU budget less dependent on Member States, especially Germany or France. The EC proposed two sources for increasing own resources: a financial transactions tax (FTT) and genuine VAT revenue. However, the requirement that Member States unanimously agree to such proposals significantly decreases the possibility of introducing any of them.

Second, the EC wishes to simplify the system by reforming corrections of Member States’ contributions from a complex mechanism to simple lump sums, and ultimately to eliminate them. However, this solution seems to be the least realistic, given the unanimity requirement and that the greatest supporter of these changes—Parliament—does not have the required competences in this

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23 Ibidem, pp. 10–11.
budgetary area. But Parliament did not give up this issue, and some MEPs have argued that the own-resources system is an integral part of the MFF.

The Commission proposes to externalise on a grand-scale EU interest projects outside the MFF, such as the International Thermonuclear Experimental Reactor (ITER) and the Global Monitoring for Environment and Security (GMES) project, whose costs are too large for just the EU budget.25 This solution is feasible to most Member States not involved in these projects and for whom the benefits will not be visible to their government or citizens.

**The Main Groups of Interests**

In general, the Member States are divided into two factions—the “like-minded” and “cohesion friends.” However, some countries are, to some extent, neutral (Luxembourg, Cyprus, Denmark) or belong partly to both groups simultaneously (Czech Republic, Spain). These two groups present opposite standpoints on whether and how to diverge from the Commission’s proposal.26

The first group is composed mainly of net payers (those who pay more than they receive from the common coffers) and those who predict to become a net payer in the near future (Austria, Germany, Finland, France, Italy, the Netherlands, Sweden, United Kingdom). They have similar positions on minimising the overall budget and cohesion policy. This is because they are relatively well developed, and only small amounts of funds may be spent in these countries. This is caused by the mechanisms of the cohesion policy (the so-called Berlin methodology) and rural development in the Common Agricultural Policy that make the least developed regions the biggest beneficiaries. These two items would stand for about 42% of all EU spending in the new MFF. Contrary to this area, the other subheadings (notably direct payments) are distributed independent of a region’s welfare, so more affluent countries benefit from these sources of funding. Hence, the proposed limitation of the common budget by this group does not contain cuts in direct payments, research and development, and the Global Europe initiative.

These facts mean the “like-minded” group generally is eager to slash the EU financial framework by minimising cohesion policy and maintaining the size of the other headings. But within this group there is some discord about how to

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26 *Ibidem.*
spend the EU’s money. Nordic countries wish to use funds to improve innovation and competitiveness, whereas some other countries are struggling to achieve a satisfactory level of direct payments or simply wish to minimise their negative net positions. There are also divisive issues on the revenue side of the budget. In general, the group wishes to maintain the status quo in the revenue structure of the EU budget, including correction mechanisms; however, the opinions within the group are divided (i.e., the United Kingdom rejects the FTT, while France is eager to implement it). Nevertheless, these bones of contention are not so grave as to break the group’s unity in struggling for a smaller budget.

The second group, “cohesion friends,” benefits from a larger budget, and particularly from significant shares of cohesion policy funds. The objective of this group is to maximise the funding from cohesion policy, and, in most cases, to also maintain or increase the budget. However, with the financial crisis, the group would be satisfied with maintaining the status quo. These countries see this policy as beneficial not only to them but also to the whole EU, due to cross-border contracts, investment, and trade. They also argue that not only cohesion policy but also the general EU budget are small but worthwhile investments that contribute to growth in grave times of economic and sovereign debt crises. However, the most important aim for most of these countries is to maintain their positive net positions in the EU budget from huge financial inflows of structural funds. This group is mainly composed of the new Member States along with Greece, Spain, and Portugal. However, it is an unstable coalition since some regions in most of these countries have been developing, and less structural funds may be allocated to them, hence some countries are limiting their support to increasing the budget and cohesion policy. This is the case for Spain, which would not receive as much from structural funds in the next financial perspective as it gained from the current financial framework, and needs more money to boost growth and jobs (including promoting labour mobility and developing new labour competences). Also ambiguous is the Czech Republic’s position, which on one hand would like to maintain funding for cohesion policy, but on the other hand has several times signed letters by net payers to limit the budget. Its position is based on Czech calculations that they will become net payers in 2018.

The discussions at the General Affairs Council, a formal forum for MFF bargaining, will accelerate after the presidential elections in France. The talks conducted at the GAC so far, look more like a ritual dance than a real desire to quickly find a decent compromise. The Polish presidency, which began the talks,
was not determined to push the negotiations forward. Poland would have had difficulties being an honest broker on issues such as consistency and agriculture, since it is the biggest net beneficiary in the EU budget. However, avoiding this dilemma was not extremely difficult as the first phase was mainly technical. The report of the first negotiations phase in the second half of 2011, except for some general statements, proves that the concept of European Added Value, even though present in the negotiations, has no practical significance.27

The Danish presidency, during which the real talks on the EU budget began, started with a declaration to end the GAC phase in June with the presentation of a negotiating box.28 The first serious discussion of the GAC on 27 January showed the fairly firm stance of Germany, which requested a 10% reduction in the Commission’s proposal of 29 June 2011.29 On 26 March, the attempt to reduce the financial perspective was repeated. Some Member States, including Germany, the UK, the Netherlands, Sweden, and Austria, proposed to take the level of the 2012 budget as a starting point for discussion. They claimed that the 2012 expenditures should be simply multiplied by seven, contrary to the Commission’s proposal, which took the year 2013 as the basis for calculation. This met with criticism from Commissioner Janusz Lewandowski, who claimed that MFF ceilings are never attained, as the yearly budget is considerably lower than the ceilings. He added that “it would be a real disaster to build the future of European projects basing on very low level of payments for 2012 producing cash-flow problems in the Commission already now.”30 This proposal by the five Member States was contested by Poland and Hungary. Polish European Affairs Minister Mikołaj Dowgielewicz called the Commission’s proposal of 29 June 2011, the “absolute minimum.”31 Some of the Member States demanded further cuts in administrative expenditures. It must be noted that the discussion did not touch the most sensitive points, such as cohesion policy or CAP, because the


28 Negotiating box is the gap to be filled in the final phase of negotiations. In general, this box covers the size of specific items of the financial perspective and has pre-determined limits that cannot be crossed.


31 *Ibidem.*
discussion would have been pointless before the results were known of the presidential elections in France.

In addition, some net contributors demanded the EU budget include all of the expenses that the EC proposed be outside the financial framework, including the European Development Fund (EDF) or even ITER and GMES, which would entail significant reductions in the remainder of the budget and uncertainty about future expenses because of the fluctuating costs of these projects. Given the many heavy demands by the net payers that may significantly affect the final outcome of the budgetary negotiations, it is debatable whether the proposal has been *de facto* overturned as the basis for negotiations.\(^{32}\)

The current negotiating process, with few exceptions, can be described as fairly predictable. In fact, it resembles a theatre play in which all the actors recite the same, previously heard monologues written for their roles. It is therefore difficult to expect any revolutionary changes in the outcome. In the second half of this year, one can also expect a hard fight for the 2013 budget. The European Parliament and the Commission indicated that it will not agree to any further cuts, as it could lead to financial problems for the EU.\(^ {33}\) In addition, there is the probability that that the new funding period for 2014–2020 will be determined by the principle of “seven times 2013 (budget).”

**Financial Scenarios for Poland**

Although the outcome of the negotiations is not precisely known, it is expected that the size and structure of the next financial perspective would not substantially differ from the current one. The Commission proposed €1.083 billion (including the “outside the budget” items); however, it is likely, that some cuts will be applied. Most probably, revenues will be decreased by about €100 billion, as Germany proposed in January 2012.\(^ {34}\) A simulation of how the possible solutions affect allocations to Poland in the next financial perspective may be seen in the following scenarios based on the budget’s size and the structure of EU expenses (see Table 1 for more details):

– *Scenario 1*: Business as usual—the Commission’s proposal is ultimately accepted by all

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\(^{32}\) *Ibidem.*


\(^{34}\) G. Sebag, “Ten Ministers…,” *op. cit.*
– Scenario 2: The budget is reduced by €100 billion and only direct payments are preserved

– Scenario 3: The budget is reduced by €100 billion with cuts concentrated on cohesion policy and rural development

To simplify the view on the budget structure, “outside items” have been excluded from the calculations. The first scenario is “business as usual,” it is a negotiation base and does not differ from the current financial perspective. However, cuts are likely to be made. Moreover, there is a question as to which subheading Member States would cut in order to save money. Provided that the cuts in the next funding period are made, most savings would be achieved at the cost of cohesion policy. Hence, all alternative scenarios assume that funding of this policy will be decreased—alone or with other subheadings. In the second scenario, there is the assumption that the French successfully defend the size of direct payments and the other subheadings, which are less sensitive to the other biggest net payers, are lowered. In the third scenario, the other net payers emphasise maintaining the size of the other subheadings, and successfully win concentrated decreases in rural development and cohesion policy.

When calculating allocations to Poland and the Polish contributions, the Commission’s proposal forms the base, along with the Commissions’ financial reports on the ongoing financial perspective, assuming that the shares of expenditures in Poland in particular subheadings would not diverge significantly, which is probable. The calculations also assume that Poland’s share in cohesion policy would be slightly lower than in the current financial perspective, as the new category for regions will reduce the amount of funds for less-developed areas. The other factor that would diminish expenditures in this subheading is a lowering of the cap from 3.5% of GDP to 2.5% of a region’s GNI. We also believe that Poland would benefit slightly more with the “Horizon 2020” project than with ongoing research projects, mainly because Polish researchers have been through the learning process of how to apply successfully for grants and because of intensifying cooperation with other European research institutes.
Table 1. Possible Allocations to Poland in MFF 2014–2020, Scenario Analyses (€, in billions)\textsuperscript{35}

<table>
<thead>
<tr>
<th>Allocations for</th>
<th>Scenario 1: EC proposal</th>
<th>Scenario 2: Budget cut by €100 billion, size of Direct Payments maintained</th>
<th>Scenario 3: Budget cut by €100 billion, cuts in Cohesion Policy and Rural Development</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>EU expenses</td>
<td>Allocations in Poland</td>
<td>EU expenses</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>115.0</td>
<td>11.5</td>
<td>99.5</td>
</tr>
<tr>
<td>Cohesion</td>
<td>376.0</td>
<td>67.7</td>
<td>325.5</td>
</tr>
<tr>
<td>Rural development</td>
<td>102.0</td>
<td>11.2</td>
<td>88.3</td>
</tr>
<tr>
<td>Direct payments and other market-related expenses</td>
<td>281.0</td>
<td>12.4</td>
<td>281.0</td>
</tr>
<tr>
<td>Freedom and Security</td>
<td>18.5</td>
<td>1.2</td>
<td>16.0</td>
</tr>
<tr>
<td>Global Europe</td>
<td>70.0</td>
<td>3.7</td>
<td>60.6</td>
</tr>
<tr>
<td>Administration</td>
<td>62.5</td>
<td>0.3</td>
<td>54.1</td>
</tr>
<tr>
<td><strong>Total Allocations</strong></td>
<td><strong>1,025.0</strong></td>
<td><strong>108.0</strong></td>
<td><strong>925.0</strong></td>
</tr>
</tbody>
</table>

The figures in Table 1 show that maintaining the size of the budget is the most advantageous to Poland. The country may receive €67.7 billion from cohesion policy for 2014–2020. The second biggest items are direct payments and “Horizon 2020” (along with other pro-innovation items), which together deliver up to €23.8 billion. The total spending allocated to Poland amounts to €108 billion, provided the EU budget is not cut by €100 billion, according to the German proposal. If so, the decrease in allocations to Poland depends on which subheading would be cut. In Scenario 2, the cash flows to Poland would decrease to €95.2 billion. But the worst case is when the cuts are concentrated on cohesion policy and rural development. This would cause additional losses of funds, and all allocations to Poland would drop to €89 billion. If this scenario were realised, Poland would lose €19 billion when compared to the Commission’s proposal. It is 17% less money from the EU, in comparison to the BAU scenario.

The revenue side of the budget is also very important in negotiations, and different outcomes may be possible for Poland in case other solutions are made by the GAC Council. First, the size of the budget determines the magnitude of the total national contributions (in particular, GNI-based ones). Also, the implementation of an FTT would have an influence on the size of Member State payments. But the replacement of a VAT-based contribution with a genuine VAT own resource—even if successfully applied—would not change the Member States’ overall net positions. In Table 2, a simulation of the structure of the EU revenues, and the size and structure of the Polish contribution to the common budget, is shown. In the calculations, the assumption exists that the structure of revenues will remain similar in the next MFF, as long as an FTT is not implemented and the size of the budget is not decreased. If the budget is decreased, the proportion of specific revenues would change since GNI-based contributions complement the other resources. Also presented is a scenario based on the Commission’s calculations of revenue collected through an FTT (presented at a conference organised by the European Commission, European Parliament and Danish Presidency on 22 March in Brussels), which estimated the level would be €400 billion and would cut GNI-based contributions in half. However, the authors believe such revenues are not fully realistic, hence the assumption that only one-third of GNI contributions would be replaced by an FTT.

The scenarios for EU revenues are:

- Scenario 1: Business as usual—FTT is not applied, budget is maintained
- Scenario 2: FTT is applied, budget size is maintained (Commission’s proposal)
  - Scenario 3: FTT is not applied, budget is decreased
  - Scenario 4: FTT is applied, budget is decreased
Table 2. Poland’s Possible Contributions to the MFF 2014–2020, Scenario Analyses (€, in billions)\textsuperscript{36}

<table>
<thead>
<tr>
<th>EU revenue sources</th>
<th>Scenario 1: Budget maintained, FTT not included</th>
<th>Scenario 2: EC proposal</th>
<th>Scenario 3: Budget cut, FTT not included</th>
<th>Scenario 4: Budget cut, FTT applied</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>EU revenues</td>
<td>Poland’s contribution</td>
<td>EU revenues</td>
<td>Poland’s contribution</td>
</tr>
<tr>
<td>GNI</td>
<td>775.0</td>
<td>25.6</td>
<td>516.7</td>
<td>17.1</td>
</tr>
<tr>
<td>Custom duties</td>
<td>114.4</td>
<td>3.3</td>
<td>114.4</td>
<td>3.3</td>
</tr>
<tr>
<td>VAT</td>
<td>135.5</td>
<td>5.0</td>
<td>135.5</td>
<td>5.0</td>
</tr>
<tr>
<td>FTT</td>
<td>0.0</td>
<td>0.0</td>
<td>258.3</td>
<td>1.4</td>
</tr>
<tr>
<td>Corrections (including British rebate)</td>
<td>–</td>
<td>2.4</td>
<td>–</td>
<td>2.4</td>
</tr>
<tr>
<td>Total contributions and own resources</td>
<td>1025.0</td>
<td>36.3</td>
<td>1,025.0</td>
<td>29.2</td>
</tr>
</tbody>
</table>

As for EU resources, the most advantageous case to Poland is when FTT is applied to the financial perspective, and the budget size is decreased. The Polish contribution would then amount for €25.9 billion in the whole financial perspective. In the other scenarios, Poland would pay more funds to the common budget. The second best scenario is if the Commission’s proposal is fully accepted (hence, the FTT is applied, and the budget size is maintained), which would mean that the Polish contributions are higher by €3.3 billion, compared to Scenario 2. Not implementing an FTT brings about the worst results for Poland. In Scenario 3, Poland’s payments would amount to €33 billion, and a continuation of a current perspective, in Scenario 1, would mean Polish contributions would be €36.6 billion.

\textsuperscript{36} Ibidem.
Table 3. Poland’s Possible Net Positions, MFF 2014–2020, Scenario Analyses (€, in billions)\textsuperscript{37}

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Allocations to Poland</th>
<th>Poland’s payments</th>
<th>Net position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scenario 1: Budget maintained,</td>
<td>108.0</td>
<td>29.2</td>
<td>78.8</td>
</tr>
<tr>
<td>FTT applied (EC proposal)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Scenario 2: Budget maintained,</td>
<td>108.0</td>
<td>36.3</td>
<td>71.7</td>
</tr>
<tr>
<td>FTT not included</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Scenario 3: Budget decreased,</td>
<td>95.2</td>
<td>25.9</td>
<td>69.3</td>
</tr>
<tr>
<td>direct payments secured, FTT</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>applied</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Scenario 4: Budget decreased,</td>
<td>95.2</td>
<td>33.0</td>
<td>62.2</td>
</tr>
<tr>
<td>direct payments secured, FTT</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>not included</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Scenario 5: Cuts in cohesion</td>
<td>89.0</td>
<td>25.9</td>
<td>63.1</td>
</tr>
<tr>
<td>policy and rural development,</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FTT applied</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Scenario 6: Cuts in cohesion</td>
<td>89.0</td>
<td>33.0</td>
<td>56.0</td>
</tr>
<tr>
<td>policy and rural development,</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FTT not included</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

In the Table 3, all the allocation and contribution scenarios are presented, which enables calculations of Poland’s possible net positions. What is interesting is that the difference between the outcomes of the most-positive and most-negative scenarios amount to €22 billion, or about 20% of possible EU funds for Poland. It appears that the most advantageous solution is when the Commission’s proposal is fully accepted by all Member States (hence, a financial perspective above €1 trillion, with FTT applied). This proposal provides €78.8 billion net funds in 2014–2020. The second-best option is if the budget is preserved but the FTT is ultimately rejected, a plan that delivers €71.1 billion to Poland. If the financial perspective is cut, the best option then is if the cuts are spread across most subheadings (excluding direct payments) and the FTT is included in the EU’s revenue system. This case results in €69.3 billion towards Poland’s net position. The next best option for Poland is if the FTT is applied but cuts in expenses are concentrated on cohesion policy and rural development (Poland’s balance would amount to €63.1 billion). In the worst-case scenario, Poland nets €56 billion if cuts are concentrated in cohesion policy and rural development and there is no consensus on applying the FTT. The second-worst outcome would be if the FTT were rejected and the cuts spread across all the subheadings (excluding direct payments). This scenario provides Poland with €62.2 billion.

This means that the Commission’s proposal would be the most advantageous for Poland, yet it is not feasible to the net payers, who will fight for satisfactory

\textsuperscript{37} Ibidem.
changes to the structure and size of the financial perspective. The other possible scenarios proposed by the net payers would only shrink Poland’s outstanding net position, leaving simply the question of by how much.

Perspectives

The problems outlined above concerning the future shape of the new funding period clearly show that this process is largely politicised and based on thinking dominated by a given Member State’s net position. The examples of different courses the negotiations may take show that in this fiscal game, especially for net beneficiaries, billions of euros are at stake. For net payers, payments to the EU budget have a minor impact on their national budgets but are a politically sensitive issue. Because of that sensitivity, the use of the EU budget as an effective tool for macroeconomic governance that pushes forward the integration process will be missing in the debates. EU financing is needed not only to compensate for the differences in economic development across the Union but also to strengthen the position of the European Commission.

The crisis in the euro area still carries a risk to the EU budget in the classic sense—marginalisation. The EU budget does not meet the practical function of stabilisation, although according to theoretical research it could be justified. However, it is difficult not to agree with the notion that more money does not necessarily mean more growth or restructuring. In the EU budget, certain amounts in some funds are still mismanaged. Development of the European Union, embracing new areas, or even fighting the crisis requires at least maintaining current funding levels. It is not good if the negotiations over the budget are dominated by ministries of finance, which are devoid of a broader view of European integration. Any compromise, which looms on the horizon, certainly will be called rotten. It is difficult to expect any major changes in revenue and expenditure, with the exception of freezing the EU general budget—a de facto reduction. The next medium-term budget review will probably take place in 2016. If it happens then and Europe has emerged from the acute phase of the crises, there will be a need for a mature and thorough discussion of the future of EU finances, one in which there will be no “sacred cows” such as a system of rebates, cohesion transfers or direct payments. Of course, this is if the European Union manages to survive as it stands now.

The Eurozone Crisis and Emerging Market Economies

Introduction

The global financial crisis that has unfolded since the collapse of Lehman Brothers in September 2008 is described as the most severe since the 1930s. But in contrast to the 1930s crisis, in the first decade of the 21st century, the global economy is characterised by very strong economic and financial links among various parts of the world. Turbulence in one region quickly spills over to other regions. In the first wave of the latest crisis, the financial systems crisis and then a real economic crisis in advanced economies had a strong magnitude on emerging markets (EM) in every region of the world through financial, trade and commodity price channels. The second wave of the crisis, which had its sources in the sovereign debt problems of the eurozone, seems to be less dangerous for emerging markets, especially BRIC1 countries, which despite strong trade and financial relations with the EU are better suited to withstand the risks associated with a spillover of the EU’s economic problems.

The main objective of this paper is to present the impact of the eurozone sovereign debt crisis on emerging market economies. The first part explains the major channels for a spillover of the crisis and indicates which emerging market regions and countries were the most exposed. The second part is focused on the impact of the eurozone crisis on BRIC economies, which in recent years due to rapid economic development contributed strongly to the total economic growth of the world economy. The final part addresses the reactions of BRIC as a group or as individual countries to the economic problems of Europe and tries to assess their ability and willingness to support the EU in its fight with the sovereign debt crisis.

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1 BRIC is an acronym for major emerging economies—Brazil, Russia, India and China. Although in 2010 South Africa formally joined the group and the term BRICS is often used, due to the relatively small size of the South African economy, this paper will mostly concentrate on the original members of the group. The term BRICS is used only in relation to the meetings of the group, where South Africa is a participant.
Spillover of the Eurozone Crisis to Emerging Markets

Unlike the global financial crisis of 2008–2009, the eurozone sovereign debt crisis developing since 2010 has had only a limited impact on emerging market economies. Although the drop in external demand had a significant impact on their export performance to the U.S. and EU markets in 2009, the second wave of the crisis did not have the same result. More risk appeared in the financial links between emerging markets and the euro area, as troubles experienced by European financial institutions affected their operations in overseas markets.

The financial channel remains the main area with a spillover effect from the eurozone sovereign debt crisis. Because eurozone banks are major holders of risky equities from such countries as Greece, Portugal, Ireland, or Spain, they had to improve their balance sheets in their home markets by reducing assets in foreign ones. Euro area bank deleveraging raised concerns about global spillovers stemming from the role these banks play in international activities, including interbank lending, private credit, trade financing and even public-sector lending.

According to the Bank for International Settlement, euro area banks are major global entities in foreign claims by banks in all of these forms of lending, with shares of 25–40%.

However, a substantial share of eurozone banks’ foreign claims in emerging market economies have maturities of less than one year, which makes them easy to unwind. So, there is particular risk in the availability of trade credit, which might be especially vulnerable as maturities for this kind of credit are typically short and involve euro area banks as major players in all regions. However, in comparison with longer-term financing, short-term trade finance proved remarkably resilient during the latest capital liquidity stress. Even when euro area banks curtailed activities to limit exposure, banks from other regions were able to step in with relative ease, reflecting the standardised format, short maturity, and comparatively low credit risk of trade finance. Euro area banks reportedly maintained trade credit for established clients but otherwise implemented a restrictive credit policy. Overall, trade finance experienced some increase in U.S. dollar funding costs and some tightening in the aggregate supply of credit.

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Although among the most exposed to foreign claims from euro area banks were other advanced European and other financial centres worldwide, some EM regions were especially at risk, particularly emerging European economies. Such risk exists even when considering that a portion of foreign claims are funded by local deposits in affiliates (and hence less likely to be withdrawn) or when taking into account differences in financial conditions across the regions. For most regions, the bulk of exposures have been to banks from the core of the euro area. Brazil and Mexico have especially high exposure to claims from Spanish banks ($186 billion and $131 billion, respectively, at the end of 2011).4

The eurozone sovereign debt crisis was the factor that lead to the withdrawal of funds from emerging markets (asset repatriation) by euro area investors. In mid-2011, $25 billion in total were withdrawn from emerging market funds.5 in parallel with more than $460 billion in portfolio inflows to the euro area from reductions of overseas assets—a large share of these by Italian and Spanish banks.6 This repatriation of funds also coincided with sharp falls in local currency bond indices in emerging markets where international investors are well represented, such as Indonesia, Mexico, and South Africa.

Problems with the balance sheets of euro area banks exposed to eurozone sovereign debt increased global risk aversion, and that increased the general vulnerability of emerging market economies to the eurozone crisis. When total foreign exposure to banks—not just to euro area banks—is taken into account, the potential for broader vulnerability is much higher. Once again, Western Europe and other advanced economies were the most exposed, as well as emerging European economies and former Soviet Union (FSU) countries with strong financial links with euro area financial institutions. Nevertheless, an increase in global risk aversion and lower financial liquidity could negatively affect emerging market economies that have weaker macroeconomic indicators. This is of particular concern for countries with current account deficits, low foreign currency reserves to cover short-term debt (including the current account deficit), or that need to cover their balance of payments from external sources. Furthermore, due to problems with budget deficits and public debt, there are

large fiscal financing requirements that, to a significant degree, are financed externally in a number of EM economies. Finally, some have a high share of foreign currency denominated loans, which implies large negative balance sheet effects on the private sector in the event of exchange rate pressure, and which could expose banks to indirect foreign currency risk. A deeper or prolonged crisis in Europe would likely result in higher global risk aversion, drawing portfolio investors away from the emerging markets. If that happens, stock markets in several EM economies could plummet once more, reducing investor confidence, with adverse effects on the real economy.

Besides emerging European economies and FSU countries, the Middle East and North Africa (MENA) region has also shown some vulnerability, with high rollover needs to service public domestic debt in some economies, which could be problematic if domestic sources of public financing such as banks are further affected by the euro area crisis. In sum, several emerging markets have suffered outflows of funding from non-eurozone banks, while advanced economies have seen inflows from these sources, which may signal an increase in global risk aversion.

Because of the outflow of funds from emerging markets to advanced economies and the lower level of capital liquidity, the general lending conditions in emerging markets have deteriorated significantly, especially during the third and fourth quarters of 2011. Among the EM, the strongest declines have been in Europe, then Africa and the Middle East. Although growth in real credit to the private sector has not shown a significant change, the deterioration of funding conditions on international markets was a major reason for the tightening, and a majority of banks in all regions have attributed the tightening, at least in part, to financial strains in the euro area.

Another channel for the spillover of the eurozone crisis to EM economies was volatility in nominal currency exchange rates. In the midst of the outflow of funds from euro area bank affiliates in emerging markets, the conversion of EM assets into euros put downward pressure on EM countries’ exchange rates, which fell sharply in September. This effect was especially dangerous in countries with large foreign liabilities, and led reportedly to intervention in the currency

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7 International Monetary Fund, *World Economic Outlook—Growth Resuming, Dangers Remains*, op. cit., p. 78.
8 *Ibidem.*
markets by several central banks, including in Brazil, Hungary, Indonesia, Korea, Russia, and Turkey, which supported their currencies.\(^9\)

Finally, the constrained capital liquidity had an impact by weakening issuances in bond and equity markets, an alternative to bank credit. The crisis pushed up bond yields in some regions as foreign investors fled to “safe haven” assets. Recent data for 2012, though, on fund flows to emerging markets shows strong inflows, signalling that global risk aversion may have decreased.\(^10\) Bond and equity markets can substitute for bank loans mainly in advanced economies, but in emerging markets these are still small relative to the size of the economy.\(^11\) Nevertheless, further deterioration in the eurozone, particularly the developments in Greece’s fiscal woes, might lead to additional euro area bank deleveraging and a substantial increase in global risk aversion. These factors could increase the likelihood of a broader retrenchment of all sources of funding in EM economies. In this scenario, it would be more difficult and more expensive for companies to raise funds in bond markets, and firms could face liquidity crises as financing becomes more difficult. Countries with more external bond holdings would likely be affected as fund outflows would have greater impact, as in the case of some Asian markets where, for example, Malaysia and Indonesia have large foreign holdings in government bonds.\(^12\)

In general, most emerging economies were not significantly affected by the eurozone sovereign debt crisis, which had a limited impact on their GDP growth, the result of stronger financial systems than in past financial crises. Despite the deleveraging by euro area banks, these economies’ domestic financial markets have the capacity to substitute bank credit (although not fully) with other sources of funding. Their domestic financial systems appear on average well-capitalised and have the potential to fill gaps. This relates especially to countries with strong domestic growth that might be in a better position to substitute funding, thanks to healthy banking and corporate sectors. In other emerging markets, especially in Asia and Latin America, credit demand is holding up well, but strong

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\(^12\) Asian Development Bank, *How can Asia Respond to Global Economic Crisis and Transformation?*, Mandaluyong City, 2012, p. 11.
economic growth may generate additional sources of financing that can substitute for bank lending.

Another factor that made EM economies well suited to withstand the spillover from the eurozone crisis is that they have strong macroeconomic fundamentals. In countries where there is enough policy room to manoeuvre, policymakers appeared be able to offset some of the impact of the bank deleveraging by relaxing fiscal or monetary policy. Compared with pre-2008 global financial crises, the fiscal position of most regions, measured by the budget balance and public debt, has deteriorated substantially, especially in advanced economies. But debt levels and deficits remain more moderate on average in emerging markets, but some economies (for example, in emerging Europe and the FSU) lack the fiscal room to manoeuvre and may actually have to tighten fiscal policy in case of a renewed downturn and added financing pressures. As far as monetary policy is concerned, advanced economies such as the eurozone, Japan, the UK, or the U.S., have very low interest rates (in some cases close to zero) with little room for easing monetary policy. Monetary easing could also be constrained in some emerging market economies that face inflationary pressure (India, Indonesia, Korea) or are still dealing with previous credit expansions (China). However, in these economies, the decline of credit expansion might also play a role in reducing an overheated economy. Other emerging market authorities responded to capital outflows by selling some foreign currency reserves in a bid to smooth exchange rate changes. On local bond markets, there was generally less selling pressure, although in some cases, notably in Indonesia, the authorities intervened heavily in local bond markets to cushion the withdrawal of foreign investors. Furthermore, several EM central banks, such as those in Brazil, Chile, Indonesia, and Thailand, reduced their policy rates using monetary expansion to stimulate growth when forecasts had been verified downward.

In contrast to the post-Lehman crisis, the external pressure on financial systems in emerging markets was largely confined to deleveraging by eurozone banks. Although EM exposure to the negative impact of the sovereign debt crisis in Europe seemed broad-based (growing risk aversion, rising cost of credit), some factors contributed to relative stability on internal markets. Especially domestic banks, as well as those of other advanced economies, were now in a better position than after the burst of the first wave of the financial crisis to step in and cushion the impact of deleveraging by eurozone banks’ on the amount of overall credit offered. Non-euro area banks reduced credit to emerging markets
more gradually (contracting by 2% in the third quarter) than to their euro area peers (a contraction of 8%), and after a rapid earlier expansion through mid-2011. Moreover, the recent stabilisation of the markets has reportedly allowed local and regional banks in Asia and Latin America to fill the gap left by European banks in some lending segments.\footnote{13}{International Monetary Fund, \textit{Global Financial Stability Report}, \textit{op. cit.}, p. 43.}

However, the new financial regulations introduced in response to the recent problems faced by euro area banks could have a longer-term impact on their operations in emerging markets. In order to reduce the risks of unhealthy lending policies and actions by banks to the financial system, and hence to the real economy, euro area banks are under regulatory and market pressures to move to a more robust funding model with less reliance on wholesale markets. This factor could permanently reduce their presence in countries where they lack a deposit base. This is especially true for euro area banks that do business in Asia, whereas operations in emerging Europe and Latin America tend to involve large deposit franchises.

After a sharp decline during the second half of 2011, when strains in the eurozone area increased, portfolio flows and other capital flows to emerging markets have rebounded strongly in 2012, partly due to the recent stabilisation of euro area financial markets and slowing down the pace of bank deleveraging.\footnote{14}{Institute of International Finance, \textit{Capital Flows to Emerging Market Economies}, \textit{op. cit.}} With reduced concern about risks in Europe, investors have again noticed the attractiveness of emerging markets and their advantages as strong growth prospects and resilient public and private balance sheets. The renewed optimism has helped prompt some equity markets (notably in Brazil, India, and Turkey) to rally since the end of 2011, while dollar funding pressures have eased and bond issuance has rebounded.\footnote{15}{International Monetary Fund, \textit{Global Financial Stability Report}, \textit{op. cit.}, p. 43.}

However, EM policymakers face a double risk, and must also be prepared for the possibility of sudden inflows and outflows of portfolio capital. On the one hand, the effect of expansionary monetary policies in advanced economies, coupled with the relative attractiveness of emerging markets, could lead to a further resurgence in capital flows that could strain the capacity of local markets and build up new vulnerabilities over time. On the other hand, further deleveraging by European banks in the event of another wave of deterioration in the eurozone financial market might lead to new portfolio outflows. Although

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\footnote{13}{International Monetary Fund, \textit{Global Financial Stability Report}, \textit{op. cit.}, p. 43.}
\footnote{14}{Institute of International Finance, \textit{Capital Flows to Emerging Market Economies}, \textit{op. cit.}}
\footnote{15}{International Monetary Fund, \textit{Global Financial Stability Report}, \textit{op. cit.}, p. 43.}
countries in emerging Europe are particularly exposed in this regard, most emerging markets have policy space to counter adverse shocks, although the opportunities for easing credit policy are more limited in EM economies in the advanced stages of the credit cycle.

**Impact on BRIC Economies**

Economic development in the major emerging market economies represented by BRIC became one of the main engines of world economic growth in the first decade of the 21st century, vindicating their position in the international economic relation. Together with South Africa, a new member of the group, their economies’ share in world GDP (in PPP terms) increased from 16% in 2000 to almost 25% in 2010, and their contribution to PPP-adjusted global GDP amounted to 55% during 2000–2008. They were not immune to the impact of the global financial crisis of 2008–2009, especially in its impact on the real economy, such as the drop in demand for exports to major advanced economies, the availability of credit for domestic enterprises, or the decrease in commodity prices. However, in general, Brazil, Russia, India and China were able to came back quickly on a stable growth path, achieving GDP growth in 2010 of 7.5%, 4.0%, 8.8% and 10.4%, respectively.16 The recent eurozone sovereign debt crisis affected BRIC economies to a lesser degree, as they enjoyed better macroeconomic fundamentals, but they were not isolated from the spillover effects, either in trade or finance.

**China.** The major impact of the eurozone crisis on the Chinese economy was in trade. The EU27 account for more than 20% of China’s total exports, so the spillover effect of the deterioration in financial markets on the real economy, especially on European demand, is the main concern for China. Data on EU-China trade indicates slower growth for Chinese exports to the EU (3.4% in 2011 compared to 31.9% in 2010), nevertheless the impact of strained demand was less than it was post-Lehman, when PRC’s exports to the EU dropped by more than 30% in 2009 alone.17 However, there is a risk that a further decline in demand in the euro area would negatively influence corporate and financial sector balance sheets, hampering the performance of firms in the export-oriented sector (where excess capacity is already prevalent), increasing the level of non-performing loans, and potentially prompting banks to deleverage. This

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would further reduce investment, employment, and growth, and could trigger a decline in China’s property market. Although China has not, in response to weaker external demand, implemented any fiscal stimulus similar to the one introduced in late 2008, a further drop could lead to broad-based consumer and asset price deflation. China’s vulnerability to external shocks has been highlighted during the global financial crisis, when global growth fell by around 6.5%. In China, even after a huge credit and fiscal stimulus response, which boosted growth by at least six percentage points, growth still fell by five percentage points.18

The closed market for foreign portfolio investment and capital accounts prevented China from euro area financial spillovers. Foreign banks’ claims on Chinese banks are less than 1% of Chinese bank liabilities, while foreign assets of Chinese banks—including sovereign debt—represent only 2% of their total assets.19 In addition, given the large deposit base, Chinese banks do not depend on wholesale funding and limited access to credit from foreign sources or foreign bank affiliates operating in China, meaning that domestic non-financial corporations have minimal reliance on external funding. Nevertheless a sharp fall in the equity markets of European and other advanced economies affected investment sentiment and increased risk aversion, which fed through to China’s equity markets and may also create disruptions in the availability of trade credit.

**India.** India is mainly a domestic-oriented economy with a share of exports to GDP slightly above 10% in recent years. Exports to the EU27 comprise about 20% of its total exports, and its diversification across other countries make it less vulnerable to decreases in import demand from the European market. The eurozone crisis did not affect exports from India, which rose in the EU27 in 2011 by 16.2%.20 One of the factors that contributed to the good performance of the export sector was the depreciation of the rupee against major currencies, which improved the competitiveness of Indian commodities.

The impact of the euro area crisis on the Indian economy was more profound in finance. Although India’s exposure to European banking capital is estimated

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18 International Monetary Fund, *China Economic Outlook*, IMF Beijing Office, Beijing, February 2012, p. 6.
19 *Ibidem.*
at only $10 billion in total, but given foreign banks’ small retail presence in India, their claims on India are mostly cross-border and short term, exacerbating the vulnerabilities. Moreover, European banks are important providers of trade credit and major players in foreign exchange derivatives markets. Global banks so far are reducing their claims slowly and are being replaced by other banks, especially from the region, compensating for a sharp and abrupt deleveraging. Domestic banks, especially public banks that would likely benefit from deposit flight, also have helped replace foreign financing.

But as seen in the second half of 2011, spikes in global risk aversion and the accompanying outflow of capital from emerging markets to advanced economies lead to larger depreciation for the rupee than for other regional currencies, because India’s current account deficit is increasingly financed by external commercial borrowing and portfolio investment, and hence is more vulnerable to sudden stops of capital inflows. The flexibility of the exchange rate remains a useful buffer against external shocks. Since the global financial crisis of 2008–2009, and until August 2011, India’s central bank intervention on the foreign exchange market was minimal, and recent interventions have fallen within the stated policy of intervening only to address severe market dislocations and foreign exchange liquidity shortages. Measures introduced to restrict banks’ net open positions on foreign exchanges and enterprises’ ability to trade in the onshore forward market contributed to stabilising the rupee.

Russia. The eurozone crisis did not affect bilateral trade with the European Union, which saw strong Russian export growth to the EU27 markets (25.9% in 2011), mainly due to high energy and mineral product prices, the main commodities of export from Russia. But the impact of the eurozone crisis on Russia in finance was more significant than for any other BRIC economy. Although Russia achieved a huge surplus in its current account, balance of payments data show that the capital account deteriorated considerably in 2011, as uncertainty about the global recovery and concerns over the euro area led to an outflow of capital. According to preliminary estimates, the capital account deficit amounted to $76 billion in 2011 (compared to $26 billion in 2010) and

almost half of the capital account deficit was registered in the last quarter of 2011,\textsuperscript{24} when the European financial markets’ problems intensified. In spite of high oil prices and robust growth prospects, net capital outflows intensified, mainly in response to worries about an escalation of the euro area debt crisis and a slowdown in the global recovery. However, investors’ concerns about the quality of the investment climate and domestic political uncertainty during the election period in Russia are likely to have affected capital flows.

Due to the size and liquidity of the Russian market, changes in global market sentiment tend to affect Russia more than in smaller emerging markets. At the same time, it is worth noting that net capital outflows remained far below their peak in 2008, when it reached almost $134 billion,\textsuperscript{25} especially when measured in percent of GDP. In addition, as Russia moves towards a flexible exchange rate strategy, net capital outflows are a typical counterpart of current account surpluses. Russia’s sales of goods and services abroad translate into the acquisition of foreign assets.

Another channel for the transmission of the eurozone crisis to the Russian economy has been through exchange rate volatility. The outflow of capital, and concerns about the euro area, contributed to the pressure on the ruble, which depreciated in late 2011; however, it appreciated again as oil prices rose and global market sentiment improved in early 2012. Although the Russian central bank allowed greater flexibility in the exchange rate as part of a gradual policy shift to inflation targeting, in 2011 it used about $13 billion to intervene in the currency market.\textsuperscript{26}

\textbf{Brazil.} Brazil had better economic fundamentals to withstand changing sentiments in the global financial markets. Its accumulation of international reserves stood at $352 billion at the end of 2011, in comparison to its total external debt of $301 billion. This reduced Brazil’s external vulnerability and

guaranteed that the economy would only suffer moderately from the effects of a stagnant world economy.\textsuperscript{27}

Due to relatively high interest rates and the attractiveness of Brazilian assets, there has been a great volume of capital coming into the country in recent years. In 2011, the Brazilian government decided to take some measures in order to mitigate the effects of the strong inflows of short-term capital.\textsuperscript{28} Controls on capital inflows through a financial transactions tax in some capital categories reduced their volatility by discouraging outflows (re-entering the local market requires payment of the tax), limiting short-term borrowing from abroad and reducing the composition of inflows. The 6\% transaction tax on resident short-term borrowing abroad (at below-two year maturities) and nonresident portfolio fixed income inflows have also reduced external debt and amplified FDI inflows as some companies appear to have set up affiliates in local market to avoid the controls.\textsuperscript{29} However, growing risk aversion affected the Brazilian stock market, where companies lost value, and for the year the BOVESPA index fell by 18\%, in the domestic currency, and by 24.5\% in dollar terms.\textsuperscript{30}

The impact of the eurozone crisis on trade was limited, even though the EU27 is one of the main destinations for Brazilian exports (21\% of total exports, similar to the share of Brazil’s exports to other Latin American countries). The recent problems in the euro area led to a slight decline in growth of Brazilian exports to the European market, from 22.9\% in 2010 to 13.4\% in 2011.\textsuperscript{31}

\textbf{BRIC Countries’ Reactions to the Eurozone Crisis}

Given their better macroeconomic fundamentals and strong growth prospects compared to advanced economies, in the current circumstances BRIC countries have improved their negotiating power in international forums and versus Europe. At BRIC summits and on the sidelines of various high-level meetings, the countries have tried to coordinate their positions on the major challenges on the world agenda. Although the BRIC countries have a diverse set

\begin{itemize}
\item \textsuperscript{27} Ministry of Finance, \textit{Brazilian Economy Outlook}, 14\textsuperscript{th} Special Edition, Brasilia, February 2012, p. 103.
\item \textsuperscript{28} Ministry of Finance, \textit{Brazilian Economy Outlook}, Brasilia, April 2012, p. 119.
\item \textsuperscript{29} Institute of International Finance, \textit{Capital Flows to Emerging Markets Economies}, 25 September 2011, p. 16.
\item \textsuperscript{31} European Commission, \textit{Brazil Trade Statistics}, http://trade.ec.europa.eu.
of agendas and priorities, greater coordination is more likely among the nations of the group in order to enhance their voices and reverse the overwhelming Western leverage that has dominated past international economic cooperation.

Taking into account the volumes of trade between the eurozone members and each of the BRIC countries, together with the importance of direct investment flowing both ways, it is not in the interest of any of them to let the euro collapse. So, questions of global financial stability and eurozone sovereign debt crisis were present at the recent BRICS summit in Sanya (China) in April 2011. There, the leaders stated in a joint declaration that the “international financial crisis has exposed the inadequacies and deficiencies of the existing monetary and financial system” and that the BRICS nations support “the reform and improvement” of this system. But their main concern was the risk of massive cross-border capital flows faced by the emerging economies, which in their view needed further international financial regulatory oversight and reform. Direct reference to the eurozone crisis appeared in the official communiqué a few months later, during the BRICS Finance Ministers meeting in Washington, D.C., in September 2011. They expressed unease towards “aggressive policy actions” taken by central banks (the Fed in the U.S. and the European Central Bank, or ECB) to stabilise their domestic economies, which led to excessive liquidity and volatility in capital flows that spilled over into emerging economies. However, they also welcomed the decision taken by the euro area countries related to the European Financial Stability Facility/European Stability Mechanism (EFSF/ESM)33 and announced openness in considering additional efforts by BRICS in working with other countries and international financial institutions to address the challenges to global financial stability.


33 European Financial Stability Facility (EFSF) is a special purpose vehicle established by the countries of the euro area (on the basis of intergovernmental agreement) whose mission is to preserve financial stability in the European Monetary Union by providing temporary financial assistance to Member States if needed. EFSF issues bonds or other debt instruments on capital markets, backed by guaranteed commitments from euro area Member States. To date, its resources total €780 billion, and it has a lending capacity of €440 billion. It will be replaced in July 2012 by a permanent instrument—the European Stability Mechanism (ESF)—which will take over the mission of the EFSF and be open to non-euro area EU countries for ad hoc participation in financial assistance operations.
(depending on individual countries’ circumstances),\(^\text{34}\) a stand confirmed at the 4\(^{th}\) BRICS summit in New Delhi in March 2012.\(^\text{35}\)

As for providing the euro area with funds for a rescue, there was no agreement on any coordinated action. Nevertheless the BRIC nations have already invested in euro assets. Detailed data are not officially disclosed, but it is estimated that the central banks of Russia, China, and India hold approximately 40\%, 25\%, and 20\%, respectively, in eurozone bonds. Lessons learnt from the past financial crisis in connection with strong growth performance allowed these major emerging economies to accumulate much higher foreign currency reserves, which serve as a cushion against sudden capital outflows when turbulence re-appears in global financial markets. The collapse of the euro is not in their interest, and theoretically some of them could invest in bonds of financially strained nations. With reported joint reserves in BRIC of more than $4 trillion, these countries, in theory, have the money required to help bail out crisis-hit countries, either through buying bonds of so called GIIPS nations (Greece, Ireland, Italy, Portugal, and Spain) or through investments in Special Investment Vehicles—bonds guaranteed by the EFSF. However, they have become very reluctant to spend much more of their international reserves buying a now risky currency.

A persistent issue since the beginning of the euro crisis has been the question of whether China, a country with the world’s largest foreign exchange reserves, would provide Europe with any significant amount of money for their rescue plans, and if so, what political demands it would make in exchange for this favour. What has been observed then are the rumours about possible large Chinese investments every time a senior Chinese official has visited Greece, Ireland, Portugal, Spain or Italy. The reality, though, is that no very large verifiable transactions have taken place. The involvement of countries such as China, with immense amounts of liquidity, does not fail to inspire market confidence as was seen when China announced that it would purchase a billion euro of Spanish debt. The bond auction was oversubscribed and lead to a turnaround in market confidence in Spanish debt even though China only


committed €400 million. The total Chinese exposure to the eurozone’s periphery financial assets has remained trivial, while the limited direct investments that have taken place have been strictly on a commercial basis as Chinese firms expand abroad. Given that Europe has relatively fewer national security concerns than the U.S., it is expected that ongoing Chinese commercial investments in the EU will accelerate in the future.

Late last year during the visit to Beijing by Klaus Regling, Chief Executive Officer of European Financial Stability Facility, the Chinese government was not convinced to directly invest in the EFSF, when European leaders suggested that the fund could be “leveraged.” In February 2012, during the annual EU-China summit, Prime Minister Wen Jiabao, as well as China’s central bank governor, Zhou Xiaochuan, said that China would continue to invest in euro debt and would increase its participation through the IMF, EFSF and the future ESM. However China prefers not to risk too much to assist the euro in its hour of need, preferring to invest in undervalued assets or infrastructure through its sovereign wealth fund (China Investment Corporation), which received a new injection of funds worth $30 billion from the government to buy assets in debt-stricken Europe. Eventually, China opted to contribute to support the euro through the much safer option of the IMF. In doing so, China will benefit from the European crisis by securing more voting power at the IMF, commensurate with the size of China’s pledge to that organisation.

Meanwhile, European leaders will be aware that as the crisis has unfolded, China has continued to gradually shift its foreign exchange reserves away from the U.S. dollar and, quite likely, into the euro. In undertaking the move to diversify its reserves, the Chinese government has adopted a sensible risk-management strategy. This ongoing diversification has helped ensure that the euro has retained its value throughout the crisis, despite widespread market predictions of its imminent collapse. But given that Europe is China’s biggest export market, the Chinese government has a good reason to ensure the dollar—and by extension, the RMB, their domestic currency—does not fall too far against the euro. Implicit Chinese support for the euro in the global foreign

exchange rate market via ongoing diversification is therefore hardly something the eurozone leaders need to thank Beijing for. After all, whatever euros China has bought, it has done so with its own best interest in mind.

Other BRIC countries are even less inclined to commit their money to bail out debt-stricken eurozone economies. The only concrete offer came from Russia, when during the EU-Russia summit in December 2011 the top economic advisor to President Dmitry Medvedev announced that the country could mobilise up to $20 billion in extra resources for the eurozone through the International Monetary Fund. But in contrast to other countries, at the spring meeting of the IMF and the World Bank in April 2012, BRIC countries did not make any specific pledges concerning their contribution to meet the goal of increasing IMF resources by $430 billion, available for countries in trouble. Although, in private they stated a readiness to contribute to reach the desired target, but not without conditions. The most clear expression of these conditions came from Brazilian Finance Minister Guido Mantegna, who repeatedly called for quicker implementation of quota and governance reform of the IMF and other international financial institutions that would give a stronger voice for emerging economies. China, India, and Russia support such a position, and the economic problems of advanced economies such as those of the United States after the post-Lehman crisis, or the recent debt crisis in the euro area provide opportunities to make their voices better heard and influence more visible.

Conclusions

EM resilience to capital flow reversals withstood the test of the crisis sparked by the fall of Lehman Brothers and the recent episodes of market stress. Many countries, particularly in Asia and Latin America, have higher stocks of reserves today than they held at the onset of the Lehman crisis in 2008. However, another sustained period of capital outflows could put severe strains on countries that have received large inflows and accumulated high short-term external debt. Heavy capital inflows to emerging markets in 2009–2011 and the greater involvement of foreign investors in local markets have also increased the amount of potential “hot money” that might depart suddenly in the face of

a severe shock. The impact of sudden outflows on credit and GDP growth in emerging markets could be considerable. Many emerging markets have internal vulnerabilities, including high fiscal deficits (i.e. India), high external deficits (i.e. Turkey and Ukraine), credit-quality concerns, and political uncertainty (notably in parts of the Middle East). These vulnerabilities exacerbate the potential susceptibility of these emerging markets to external shocks.

Major emerging economies—BRIC countries—remain inevitably exposed to volatility, including external shocks in trade and finance. Yet, in many cases they have sufficient foreign exchange buffers and policy space—monetary, fiscal, and credit—to counter a range of financial and economic shocks. The experience of 2008 in emerging economies as diverse as Brazil, China, India, and Russia was that the countercyclical use of available policy space, along with the creative deployment of targeted instruments, can be effective in sustaining growth in the face of a major external shock.

It seems that the EU has relied on its own resources to address the crisis, with the bilateral loans, and various instruments such as EFSM, EFSF or ESM supplemented by financial and technical support from the IMF, and BRIC largely playing on the financial sidelines. Certainly, the eurozone will not be willing to do any particular favours for any country, especially China, in other policy areas, as reflected by ongoing disputes over airline emissions, the arms embargo, and various trade-related issues. So, while strong economic and political relations between Europe and BRIC nations are conducted in the best interest of each party, it is unlikely the eurozone crisis will play a significant role in bringing about this outcome.

Although it is in no way certain that the balance of power will completely shift towards emerging or recently emerged nations such as BRIC states, as they are grappling with internal problems of their own, one can be relatively certain that the growing degrees of independence—both from Western policies and Western demand—will provide the perfect platform for increasing economic leverage through investments in equity and debt as well as foreign direct investments. The collapse of the euro area is not in the interest of any of the BRIC countries, taking into account the side effects of the EU economic problems on the global economy. However, it became clear that BRIC countries are hesitant to provide directly the funds the eurozone needs to stabilise its financial system and sovereign debt markets. These countries’ main role in any euro crisis resolution will likely be as part of a coordinated G20 effort, by pledging more money to the IMF.

Published as part of the International Political Economy Series by Palgrave Macmillan, this book is the joint work of 16 researchers in Latin American studies from several European and American countries. The core of the publication are 12 contributions showing various aspects of globalisation in the region.

In the introduction, Manuela Nilsson (Linnaeus University, Sweden) and Jan Gustafsson (Copenhagen Business School, Denmark) wrote the main goal of the volume was to find new ways of and problems with analysing the impact of globalisation in Latin America. They wanted to evaluate the globalisation phenomenon “in a more holistic way” and highlight the importance of analysis from “more angles.” They argue that previous approaches have focused on specific aspects of globalisation in the region (e.g. democratisation, human trafficking, the legal culture, or the environment) but seldom was the undertaking from a more complex viewpoint. Additionally, in the latter approach, most researchers have tended to make globalisation equal with neoliberal economic policy, and therefore to show its negative results on the economic and social development of Latin America. One could wonder why the editors based their observations on only English-language publications. It would be more complete and convincing if they had shown the contributions of the debate among Latin American intellectuals about the effects of globalisation on the region.1

What is called to attention in the book is the lack of a solid and uniform conceptual framework for analysing globalisation. The editors present their understanding of the concept as “a set of processes that has resulted in an increasing interconnectedness of economic, political, social and cultural systems across geographical boundaries.” However, several of the authors introduce their own understanding of globalisation and sometimes confuse it with other processes, e.g. internationalisation. Additionally, some relevant topics to Latin America, such as the relationships between globalisation and regionalisation, are hardly explained. Moreover, worth noting is the inconsistency of the timeframe that is defined. In the introduction, the editors declare that the book refers to the last two decades after the Cold War, while the title of the publication points to 21st century responses. Some contributions are even more flexible about that, focusing in significant part on broader historical backgrounds.

The individual contributions, according to the editors, have been grouped into four spheres—economic, political and social, security related, and external relations—although these delimitations are not stated between the essays. In the opening text (titled, by the way, very similarly to the book’s title), Raúl Bernal-Meza and Steen Fryba Christensen attempt to map changes in the global system and shifts in Latin America at regional and national levels. Subsequently, they describe patterns of response to globalisation by various countries, referring to their state models and foreign policy paradigms. When talking about specific countries, the authors dedicate extensive fragments to Argentina and Brazil, and much shorter insights to Chile, Colombia and Venezuela. One may agree with the authors’ conclusion that the degree of economic and political heterogeneity make it hard for Latin American countries to build one voice to confront the world system (p. 33).

The next article, by Erik Brand and Matthew Schewel, concerns the increasingly important topic of energy policy. It focuses on the two emblematic cases of petroleum-rich countries Venezuela and Brazil. The former draws attention because of the role these resources play in the policy of the President Hugo Chavez’s government. The latter has become an important player, especially after the discovery of offshore oil and gas fields (named “pre-salt”), and also as a worldwide leader in biofuels. The authors dedicate a significant part of the text on the increasing role of renewable resources. They mention the topic of regional cooperation in the energy field, but do so in a strongly superficial manner by referring only to U.S. President Barack Obama’s initiative on an energy partnership for the Americas, on one hand, and to the engagement of Brazil and Mexico in climate change debates, on the other. It would be
interesting to know more about how energy cooperation ranks in such regional schemes as Unasur and Alba, in which Brazil and Venezuela, respectively, have leading roles.

Two articles discuss the political consequences of globalisation. One, by Martin Nilsson, presents the phenomenon of the increasing position of the Left in most Latin American countries. The other, by Anne Marie Ejdesgaard Jeppesen, characterises a Bolivian case in which social movements appear to be an effective force in halting privatisation projects and bringing about political change. Both texts address the problem of disappointment with globalisation’s negative effects on the social conditions and the perseverance of exclusion and inequality.

A few articles are dedicated to the social repercussions of globalisation. Manuel Orozco elaborates on the specific aspect of international migrations and remittances. He shows how money transfers to families in Latin America play important social and financial security roles. The author claims, however, that the benefits coming from these money transfers for a country depends on the absorption capacity of local economies, and the ability of governments to address the remittance issue in their public policies. Other contributions offer insight into the lack of human security in Latin America. Thomas Shannon Stiles writes about the development of Central American gangs, and especially *Mara Salvatrucha 13*. The author describes the process of how the group has been strengthening and building networks covering the U.S. and Central American countries. He also shows how the gang has begun to be active in other countries such as Canada or Spain. Patricia Olney’s text on the security challenges in Mexico, which the in last few years has resonated with international media as one of the most violent countries in the world because of the thousands of victims of drug-related crimes. The article is interesting because of the insight into the roots of that deterioration. Olney points as an example of these causes to the political shifts related to the loss of power in 2000 (after 71 years of dominance in Mexican politics) by the Institutional Revolutionary Party (PRI), and to the consequences of Mexico’s membership to NAFTA. In the subsequent article, Dirk Kruijt attempts to describe new patterns of violence in Latin America. He argues that the process of a rising number of vulnerable and excluded citizens, as well as the existence of vast territories relatively absent state control (“government voids”) have been ground for new kinds of crime threats. Interestingly, Kruijt gives an overview of how different countries in the region are affected by these negative processes. He even claims that, paradoxically, some Latin American governments accepted peaceful coexistence with the violent non-State actors, as long as they do not threaten the national order (p. 184).

The last three texts concern the external relations of Latin America. The article by Guy Edwards and Enrique Mendizabal refers to the Latin American-European relations.

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The authors enumerate the various dimensions and complexity of the relationships. They show there is considerable potential to develop a bilateral relationship. They, however, also name challenges that derive from a diversity of views among the countries of both regions, as well as the changing relative position of Europe in Latin America to that of the U.S. and China.

William Ratliff contributed with insight into Sino–Latin American relations and the main areas of current cooperation. The author gives an interesting observation on the challenges of China’s economic expansion in Latin America. He sees advantages of these closer ties and is doubtful whether the Asian giant poses a security threat to the region. However, he argues that Latin American governments should carry out prudent investment policies to build own high-quality production capabilities in order to go beyond their dominant status as resource-suppliers.

The last text, by Steen Fryba Christensen, in the mentioned group focuses on Brazil’s foreign policy objectives and the call for South-South relations, which concerns other Latin American partners, as well as other emerging economies (especially from BRICS and IBSA), and certain countries from Africa and the Middle East. This bid for partners from the developing world could be explained by the need to diversify economic cooperation and for a strengthened bargaining position when negotiating with developed countries.

Unfortunately, there is no separate analysis on the U.S. as a partner to Latin America. In the introduction, the editors explain that they decided to not include that topic as they wanted to focus on “alternative alliances.” They then give some remarks regarding the U.S. status as the most important partner for Latin America. Nonetheless, and contrary to their arguments, it would be even more interesting to see the change in relations between Latin American countries and their still-key partner in the face of the globalisation process and the change of status in the region of other global actors (China and the EU, in particular). In the conclusions, the editors even claim that these changes could cause the U.S. to cease to be Latin America’s most important counterpart. Such an assumption appears to go too far when one considers the U.S.’s relations with its neighbour Mexico, its geographical closeness to Central America, and longstanding cooperation with Colombia. Even for Brazil, considered as a leading country in South America, close relations with the U.S. will be indispensable for it to gain recognition as a global actor.

Overall, the book brings together a particular selection of topics related to globalisation along with up-to-date data. Its main weakness, though, is the lack of a thorough framework for analysing the globalisation phenomenon in Latin America, and, therefore, of a systematic exposition of the topic. Nevertheless, individual
contributions are good points of departure for deepening knowledge on specific issues. Their importance is the rich bibliography accompanying every article, although, some are based mainly on English-language sources. Also, the name index included at the end of the book could be broadened to further facilitate moving over the text. Although the book offers only a few angles from which to see the impact of globalisation in Latin America, it should be useful for readers interested in various aspects of the development of the region.

Bartłomiej Znojek


David Rohde, The New York Times journalist, went missing in Afghanistan on 9 November, 2008. What was supposed to be a short interview with an Afghan Taliban commander was in fact a trap. Taken hostage together with his local translator and a driver, he was transferred to Pakistan’s Federally Administered Tribal Areas, where he spent more than seven months in captivity. The world learned his story only in June 2009 when he was fortunate to escape his captors. The book he wrote in 2010 with his wife, Kristen Mulvihill, is a testimony to his experiences, but also the best-to-date insight into the Taliban’s inner world and the complex realities of the Afghan war.

Interestingly structured, the book actually offers two separate but parallel and complementary narratives—one by Rohde as held in Pakistan and the second by Mulvihill, struggling tirelessly back in New York for his release. As read from those opposite perspectives and by different readers, it can be seen as a sober analysis of the history of Afghanistan and foreign interventions in the country, as passionate reportage from Taliban custody or as a moving love story of a couple separated by international politics. Rohde describes how he was moved back and forth between different hideouts in North and South Waziristan, undertook hunger strikes and a suicide attempt to build pressure on his captors and hasten his release, faced their repeated lies, accusations of being a spy and false deadlines of executions, and how, eventually, even as an atheist, he found refuge and strength in everyday prayers. Meanwhile, on the other side of the world, Mulvihill has difficult dealings with the “kidnapping industry,” making efforts to navigate conflicting negotiation strategies, hire security contractors, seek the assistance of the American administration and tackle misinformation,
and spends long weeks waiting for any contact from her partner. A well-written
and captivating story, it is a fascinating account from Afghanistan from the first
page to the very last.

The special value of this book lies in the fact that Rohde is actually one of
only a few Westerners who have spent a long time with the Taliban in their
remote and inaccessible strongholds in the Pakistani tribal areas and made their
way back to safety to report their observations. In long conversations and in
many interactions with Taliban fighters of all levels, Rohde had the rare
opportunity to better understand their worldviews, motivations and aims, as well
as their organisational structures and external links. He saw how the Pakistani
Taliban were in fact real allies to Afghan insurgents and confirms the formal
allegiance of the Haqqani Network to Taliban leader Mullah Omar. As Rohde
was kept by the Haqqanis in North Waziristan, he witnessed first-hand that
a fundamentalist Taliban mini-state in Pakistan was “alive and thriving” back in
2009. He observed with regret that “the loss of thousands of Afghan, Pakistani
and American lives, and billions in American aid has merely moved the Islamic
emirate a few miles east into Pakistan, not eliminated it” (p. 71). While political
negotiations between the U.S. and Taliban are on track in 2012, one can wonder
whether this Islamic emirate will not move a few miles West again after foreign
troops are withdrawn from Afghanistan by 2014. And there should be no
delusion that this state will be much better than what we knew from before 2001.

In one of the most interesting aspects of the book, the author gives us
a rather disturbing portrait of the modern Taliban. Rohde describes hard-core
jihadist fighters who are infused with theories about a Judeo-Christian
conspiracy against Islam and immune to basic facts. Educated in madrassas, if at
all, they have undergone further brainwashing by endlessly watching propaganda
movies that welcome every suicide mission with respect and Westerners’ deaths
with joy. Although religiously motivated, they find nothing morally wrong with
chopping off legs, decapitating people or hanging them on trees as a threat to
others. They firmly believe in jihad, perceive war in Afghanistan as a “global
struggle between faiths” and only a first step towards liberating all Muslim
countries. In one worrying fragment of the book, the author recalls a 10-year-old
student from a hardline Islamic school, to whom Rohde addressed a typical
question asked of children around the world: who would you like to become
when you grow up? “A suicide bomber” was his first choice; “a mujahedeen”
was his second option; and “a Muslim” was third (p. 272).
Still, Rohde’s description of the Taliban is not that one-sided or lacking objectivity. His testimony undermines the popular image of the Taliban as a bearded savage living in remote caves with no contact with the outside world. On the contrary, his captors were well acquainted with modern devices, used the Internet and followed world news on TV. He correctly recognises that the Taliban movement is not a monolithic block, and points at divisions between different factions and personalities. He distinguishes between hardline fundamentalists and more moderate Taliban fighters, even though he is not sure which group represents the majority or which will eventually prevail.

Rohde admits also that the Talibans’ “boundless hatred” towards the West also has some accurate reasons: the West has made many mistakes in Afghanistan after 2001, and incidents such as the killing of civilians in airstrikes or drone attacks, torture and mistreatment of prisoners at Abu Ghraib or Guantanamo, the disrespect foreign troops have shown towards the local culture, and other examples, should not have taken place. However, while for Rohde these episodes are aberrations, his captors see them as “proof that the United States is a hypocritical and duplicitous power, that flouts international law” (p. 96). We can imagine today that the incidents of early 2012, such as photos showing U.S. Marines urinating on dead Taliban bodies or the killing of 16 Afghan civilians by a U.S. soldier in March, have largely contributed to Taliban propaganda materials and made prospects for true reconciliation with the West even less likely. A Pashto saying—“a stone will not become soft, nor an enemy a friend”—points at probable difficulties of such efforts.

One specific feature of the book may make it of great interest particularly to Polish readers. At nearly the same time as Rohde was a hostage in FATA, a short distance away another group of Taliban held Polish engineer Piotr Stańczak. While the story of Rohde ends on a more positive note, this cannot be said for Stańczak, who was brutally executed on 9 February 2009, with much of his story remaining a mystery. Although the book discloses no new revelations in this regard, the captives never met, it gives us a glimpse into what the Polish citizen’s five months in Taliban imprisonment may have looked like, and how little more, unfortunately, could be done to save him. When the single most-powerful country in the world—the U.S.—had reached the limits of action in Pakistan in Rohde’s situation, there was probably much less the Polish government could have attained.

This dramatic comparison of the fates of two foreign hostages poses a difficult question about what eventually decided their different ends. Even
though the question escapes simple answers, some crucial differences can be traced. First, Rohde was an American citizen, a famous journalist, and considered as a “friend of Obama,” was regarded as a highly valuable hostage or a “golden hen that lays golden eggs,” as one of his captors described him. Although he could have been kept in detention indefinitely, his life was not threatened directly—a kind of advantage absent the case of the Polish geologist. Second, while Rohde was imprisoned by the well-established and more predictable Haqqani Network, fighting against Afghan and foreign forces in Afghanistan, Stańczak was held, according to the book, by the less organised but more ruthless Pakistani Taliban group of Baitullah Mehsud, which was in the midst of a cruel war with the Pakistani state. Finally, what possibly helped save Rohde was an initial decision to keep the story of his kidnapping from the public. Since media coverage increases the bargaining position of the kidnappers, a public deadline to meet their demands, especially in a tribal culture, increases the probability that the threats will be realised for the kidnappers to save face. Whether we can draw any lessons for similar situations in the future is not so clear. What this case shows is that the one thing no one has any influence on, yet which played a decisive role, was in the end blind luck.

As read from yet another perspective, the book may be seen as an interesting testimony to an increasingly dangerous profession of modern journalism in conflict areas. Rohde was not the first and certainly not the last journalist to be held hostage. Many have paid the highest price: Marie Colvin, an American reporter killed when the Syrian army shelled Homs in early 2012, and Sayed Salam Shahzad, a Pakistani journalist found dead near Islamabad in May 2011, are the latest famous examples. Still, Rohde maintains the proper distance from the work he does and holds journalists responsible for their choices. “In an intensifying race to the bottom,” he observes, “the reporter who took the greatest risk often received the highest acclaim” (p. 7). He admits, in his case it was both a professional requirement to have both sides of the story as well as an egotistical need to “write the best book possible” that brought him to danger. This honest confession is in fact distant from the dominant image of a war reporter as a kind of altruistic demi-god serving in the name of the oppressed and the truth. Here, his frank recollections of his torturous hesitations before making his mind up to go for the interview then the repeated regrets of the bad choice he made, give the book even more credibility and authenticity.

Naturally, readers will find here a lot of useful but already well known material about the reasons for Afghanistan’s growing instability. In several short
descriptive paragraphs, Rohde, who had been reporting from South Asia since 2001, describes the mismanagement of the Afghan intervention by the Bush administration, underlines the problems with the coordination of international aid, points at the growing mistrust between Afghans and foreigners, and dedicates much space to descriptions of Pakistani tribal areas as safe havens for the Taliban.

What is the most valuable here, however, is a critical assessment of the ambiguous role Pakistan has played in the Afghan conflict. Even though Rohde was eventually helped by a Pakistani army officer in Miran Shah, and the infamous ISI facilitated his evacuation from Pakistan, he saw enough to confirm a close relationship between the Pakistani military and the Haqqani Network. Since last year, his analysis that “with their safe havens in Pakistan, the Taliban could not be stopped” is eventually gaining ground in Washington (p. 227).

Despite the growing difficulties in the region, Rohde does not lose faith in the possibility for stability. Apart from cautious negotiations with moderate Pashtun, he suggests that the only long-term path to regional peace is through education and democracy. When the international community is about to end its military engagement in Afghanistan, it is extremely important to hear this voice and not forget about longer-term civilian commitments to the region. Without this, ideologically indoctrinated Taliban will eventually prevail over more moderate Pashtuns in Afghanistan and Pakistan.

In the preface, the authors explain they “wrote this book in the hope of helping readers learn more about Afghanistan, Pakistan and American effort there” (p. XVI). And one must admit they performed this task with excellence. Among the dozens of volumes written on Afghanistan in recent years, this one is especially worth reading, both by experts on the region and beginners in South Asian studies. As a thrilling adventure story, for many it could be just a first step towards serious analysis of increasingly complex international politics.

Patryk Kugiel

Andrzej Lubowski’s *Zbig* is not a conventional biography. It is a fascinating story of Zbigniew Brzeziński’s career as a political science theorist and practician. The book is undoubtedly absorbing reading for both those interested in the history of the Cold War, as it provides a fresh view on the role in the decision-making process of one of the most influential political advisors to the president of the United States after World War II, and also as a source of inspiration for those interested in the essence and meaning of policy-oriented analysis. This second aspect of the book seems to be the most important one. It provides the reader with valuable insight into the basic values and principles of work of a “man who undermined the Kremlin.”

Lubowski leads his readers through the most important moments of Professor Brzeziński’s professional life, basing them on rich sources of information—official documents, the memories of decision-makers and most important, on a number of interviews with Brzeziński himself. The book presents Brzeziński’s first steps in the field of political advice, the rise of the political tandem of Brzezinski and Jimmy Carter, as well as the constant presence of his strategic thought in the policy-making discourse in Washington until today. Lubowski’s story is not always linear, it concentrates on the most important milestones of Brzeziński’s career. In fact, the story is built around Brzeziński’s positions towards key challenges the U.S. administration had to face, both when “Zbig” played his most important roles as well as when he remained in the background of the political process.

Lubowski suggests that the key to Brzeziński’s success lay in the unique features of his personality. The most important was consistency, which was never blind but always based on thorough analysis. Brzeziński studied the political system of the Soviet totalitarian regime as a student. A son of a Polish diplomat, he understood the essence of the Soviet regime perfectly and was aware of its fundamental weaknesses: economic inefficiency and frozen ethnic conflicts under the cover of an imperial monolith. According to Brzeziński himself, he spent most of his mature life creating the strategy for dismantling the Soviet bloc. As a result, this pursuit, sometimes misunderstood as an obsession, meant Brzeziński would be labelled a “hawk” on both sides of the Iron Curtain. History proved Brzeziński’s diagnosis to be correct. After the fall of the Berlin Wall, he continued his mission of fighting anachronistic imperial-style
policy-making. He has lately become one of the most prominent critics of Vladimir Putin and Russia’s foreign policy, which is concentrated on building spheres of influence. He is also one of the biggest opponents of anti-Americanism in Western Europe.

Even the most legitimate and most just ideas cannot be realised if they do not find fertile ground and a favourable environment. One of the most important features of Lubowski’s *Zbig* is the fact that the book highlights the significance of networking and the ability to maintain long-lasting productive partnerships as a prerequisite for a successful analyst willing to influence the real political process. The story of Brzeziński’s success is also a story of building close professional relations with influential American public figures. Modest engagement in John Kennedy’s presidential campaign, closer cooperation with Lyndon Johnson’s administration, the establishment of the Trilateral Commission founded by David Rockefeller, and finally the peak of his career as advisor to President Jimmy Carter were all examples of good and productive collaboration based on mutual respect and trust. At the same time, Lubowski consistently rejects the myth of Brzeziński playing the role of a “grey cardinal,” steering U.S. foreign policy from behind the backs of more or less influential politicians he advised to. The author presents Brzeziński’s cooperation with the decision-makers as based on a clear division of roles. Indeed, he has always been a straight-forward and authoritative advisor. The book actually suggests that it is probably one of the best ways for a political advisor to obtain an influential position. However, at the same time, Brzeziński’s portrait is persuasive that gaining such a position is impossible without a strong intellectual background, and—more important—an attitude of partnership between the advisor and the politician.

Lubowski’s *Zbig* gives the reader a good chance to understand, how policy-oriented analysis should be constructed in order to be effective. Although there is no overview of Brzeziński’s scientific achievements in the book, it contains plenty of valuable tips that constitute coherent characteristics of Brzeziński’s political advice. The author underlines that Brzeziński’s works usually did not contain any elegant theoretical models, but always combined theory with realistic political recommendations. According to Lubowski, “Zbig” managed to utilise his solid theoretical background, perfect understanding of the essence of Soviet internal and foreign policy to create a consistent analysis that is pragmatic and at the same time clearly value-oriented. Brzeziński’s image, as presented by Lubowski, corresponds with his common image of a perfect
strategist. He has always combined a very broad (in fact global) perspective with thorough and objective analysis of a complicated network of interests that binds the global politics together. Even in the very construction of the book, Lubowski underlines Brzeziński’s understanding of links between seemingly distant and distracted processes and phenomena. Cuba, Afghanistan, China, Middle East—Brzeziński’s engagement in these was nothing but a puzzle against Soviet totalitarianism and Moscow’s autocratic domination over Central and Eastern Europe.

Such broad and comprehensive analysis is undoubtedly needed in the contemporary world. Lubowski’s book underlines it by showing the timeliness of Brzeziński’s thought process and analysis, even after the end of the Cold War. At a time when America’s attention is moving quickly towards Asia and the Pacific, Brzeziński’s expertise on Russia, as well as his lack of illusions, considering the essence of its current political regime, seems to have additional value. In his book, The Second Chance, Brzeziński provided a recipe for improvement of United States’ position in the modern world. According to it, America should become a leader supporting human dignity throughout the world, its policy should be devoid of arrogance and unilateralism. Brzeziński’s recent support of Barack Obama’s presidential campaign has proven once again that intellectual consistency should be paired with a readiness to engage so that one’s words and ideas may be heard and implemented. His rather loose cooperation with the current U.S. administration suggests that these concepts are at least present in the strategic discourse of America’s decision-makers.

Unfortunately, the book lacks some deeper reflections, considering the perception of Brzeziński’s personage among the political elites and in wider societal circles in the former Soviet republics. Lubowski repeatedly underlines that Brzeziński was often considered “public enemy number one” of the USSR during the Cold War. Taking into account Brzeziński’s emphasis on morality in international relations, such a position was quite understandable in conditions of an ideological confrontation. It is worth noting that after the collapse of the Soviet Union, Brzeziński’s fame as one of the main ideological enemies of communism made him one of the most well-known American thinkers in the post-Soviet space. In particular, his recent books have been translated into Russian and published. As a result, former adversaries continue to refer widely to Brzeziński’s ideas, regardless of whether they agree with him. This, in turn, shows another important aspect of Brzeziński’s work. The elegant simplicity, as well as precision of his analysis appeared to be perfectly readable for a number
of post-Soviet experts, raised in the traditions of thinking about international politics in terms of realism. As a result, Brzeziński’s ideas can undoubtedly be regarded as one of the important tools for engaging an expert community representing different post-Soviet republics into a dialogue with their Western counterparts.

Lubowski’s book is important not only because it is a biography of an outstanding person but also because the story of Brzeziński provides Europeans with several significant and very up-to-date lessons. Brzeziński’s approach to the design of foreign policy, based on a mix of realistic interests and tough support for clearly defined moral values, is definitely missing in the EU’s current struggle to maintain its influence in the turbulent region of its broader neighbourhood. Lubowski’s *Zbig* is perfect reading and a source of inspiration from the perspective of a person searching for ways to improve the efficiency of EU foreign policy initiatives such as the Eastern Partnership. It does not provide direct answers, and furthermore, the situation we deal with nowadays is much more complex and dynamic than in the times of the Cold War, but still the book makes the reader understand that unless any political initiative is implemented without a background of clearly defined core values, its chances to succeed remain narrow.

*Igor Lyubashenko*


Nicole Gnesotto, the first director of the EU’s Institute for Security Studies (EUISS) and current vice-president of Notre Europe, has recently released her latest book, *Does Europe Have a Strategic Future?* Published by the Polish Institute of International Affairs (PISM) publishing house (in Polish), the book is a very interesting contribution to the debate about the future of Europe.

Written as an essay, it provides details about the history of the European Union’s foreign and security policy, its defence capabilities, and the EU’s role in a changing world. However, most important, Gnesotto discusses the problems the EU faces in order to become a strategic world player. The author emphasises
that the EU has to develop common strategic thinking in order to rebuild its world position, because the EU’s strength comes from when it speaks with one voice, as a community of five hundred million citizens. If EU Member States will not overcome their tendency to think first of national interests, the EU will become a second-league player and will pass the lead to emerging powers that are becoming stronger and richer every day.

In the first part of the book, Gnesotto gives a thorough description of the EU’s defence policy and history and presents the military capabilities of the Member States and the EU as a whole. This division is important as Gnesotto points out that most Member States still think nationally rather than as a Community. EU governments often invest their defence budgets in projects they perceive to be important. This leads to a situation in which European defence investments are often duplicated, instead of being more broad and complementary. The 27 EU Member States jointly invest around €200 billion, which is approximately one-third of the American defence budget. However, what is extremely crucial to emphasise is that even with its investments the EU is far from being at one-third of the defence level of the U.S. This is because the Member States do not consult each other about their defence spending, which would allow them to build a strong and coherent “European Army” together. One must not forget that weakness in European defence capabilities is also weakness in NATO, since Member States do not have separate defence budgets for each organisation. This aspect is crucial in regard to transatlantic relations, as the U.S., which is no longer the world’s only superpower, wishes to have a strong partner in the EU to support the U.S. in the broader world, rather than mere support for Europe.

Furthermore, Gnesotto points out that another step to more successful and visible European military cooperation would be the creation of an EU operational headquarters, without which “European defence is virtual in many aspects, and does not have a permanent and visible nature, which characterises military institutions” (p. 73). The issue of establishing a permanent EU military headquarters was one of the priorities set by Poland for the second half of 2011, when it took over the EU presidency; however, due to strong opposition from London the plan did not succeed.

The lack of EU military headquarters and a coherent and effective foreign and security policy leads to the invisibility of Europe, which should not be the case since the EU engages many people and invests large sums of money in order to become an important world player. This means that the EU is
unsuccessful and not seen as an important strategic actor. The author points out that one reason for this is the capability deficit previously mentioned, whilst the second encompasses the political decisions made by Member States. Some do not agree with large publicity for the EU’s external actions due to internal politics (Ireland and neutral states), while others for ideological reasons do not want the EU to be as important in the security field as NATO (the UK). These factors show how complicated it is for the EU to become a visible and respected strategic actor; however, Gnesotto emphasises that the EU soon may not have a choice—it will have to become more effective unless it wishes to be seen and treated as a marginal player.

As the first part of the book is more academic, with comprehensive information about the history and evolution of the EU’s defence policy, the second part makes for quick reading. It concentrates on the changes in world geopolitics, the effects of globalisation, the change of the EU’s relations with the Unites States, and, finally, on the future of the EU. Gnesotto makes the point that the EU must better adapt to world changes: “Globalization commands Europeans to reconcile the two dimensions of power: civilian and military. It is no longer about making the choice between strength and standards, but about combining them in the best possible way … In the hour of globalisation, European power will either be global or it will not exist at all” (p. 96). There is therefore the need to invest in defence, modernising equipment and creating an autonomous headquarters for managing missions of broad scope, by enlarging the budget of the European Defence Agency in order to create future technologies. The European Union must be a strong partner for the United States, which is progressively withdrawing from European security in order to engage in new security issues. The European Union has to manage on its own without the support of the U.S., which for more than 50 years has provided Europe with security and opportunities for growth. Times have changed, therefore the transatlantic partnership has to be redefined. The U.S. wants a strong European partner who will not only be a military actor but also, and maybe most importantly, will be a strategic partner in such fields as economic governance, the fight against poverty, and relations with Russia.

The strong global position of the EU requires the will of all Member States to act together and to overcome the “cult of national sovereignty in diplomacy and defence” (p. 80), as Gnesotto calls it, summing that strategic Europe is currently the sum of sovereign nations, which leads to nothing but impotence. This is especially interesting as the Member States agree to delegate their
sovereignty in some fields, such as the Common Agriculture Policy, single market, free movement of goods and capital. However, when it comes to such issues as foreign policy or defence, these same countries concentrate mostly on their national interest. They do not see the whole picture, meaning that the EU is not as strong as it would be if all the states were instead united in their policies.

We are, unfortunately, witnessing this weakness. A milestone was made with the Treaty of Lisbon, which established the High Representative for Foreign Affairs and Security Policy, who chairs the Foreign Affairs Council and conducts Common Foreign and Security Policy. The concept strengthens the management and cohesion of the EU’s external actions; however, one year after the European External Action Service became operational, we still cannot talk about a strong EU foreign policy.

Europeans must realise that the EU’s long-term perspective is more important than one’s national interest. This has always been difficult for Member States to focus on, and now, with the financial crisis, it is even more difficult. Most of these countries have concentrated on their internal affairs in order to provide stability to their citizens and because they do not want to invest money in the development of various EU policies. However, if this is how the situation will remain, Europe will wake up one day and realise that it no longer has a say in world politics.

Summing up, Gnesotto provides a full picture of the current situation in the EU and presents scenarios for the future. There are basically two options: either the 27 EU Member States start thinking as a whole and agree to some policies that are not 100% good for one country but will lead to the development and strengthening of the EU, or the European Union will have to learn to live in a world in which it will have little say. Gnesotto’s book is an important contribution to the discussion of the future of Europe, and it inspires reflection.

*Anna Zielińska-Rakowicz*
Polski Przegląd Dyplomatyczny

„Polski Przegląd Dyplomatyczny”, kwartalnik wydawany od 2001 r. przez Polski Instytut Spraw Międzynarodowych, podejmuje tematy dotyczące polityki zagranicznej Polski, integracji europejskiej, bezpieczeństwa międzynarodowego oraz międzynarodowych stosunków gospodarczych. Na jego łamach propaguje się idee wspierające polską politykę zagraniczną.


http://www.pism.pl/eksiegarnia
Problem politycznej jedności w Europie
Marek A. Cichocki


David Ost,
profesor nauk politycznych Hobart and William Smith Colleges
(Geneva w stanie New York)

Przyszłość Europy strategicznej
Nicole Gnesotto

„To, co Jacques Delors nazywa godziną prawdy, sprowadza się do następującej opcji: albo Unia Europejska zdoła się zorganizować i zjednoczyć, by zaznaczyć swoje znaczenie w nowym świecie i wpływać na gospodarcze, strategiczne i polityczne przemiany globalizacji; albo kraje europejskie nie zdolają wygrać stawki zbiorowego wpływu. Unii Europejskiej grozi wówczas sytuacja, że decyzje dotyczące zachodzących w jej przemian podejmowane będą gdzie indziej i nawet największe państwa Unii zachowają na nie wpływ jedynie marginalny. Z wielkiej strategicznej lekcji, jaką jest amerykańska wojna w Iraku, wywieść można jedną ogólną naukę: Europejczycy podzielieni się nie liczą, zjednoczeni ciągle mają szansę, że swoją kulturą, swoją wizją i swoimi priorytetami współtworzyć będą przemiany świata”.

Z zakończenia książki

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