

A British Agenda for Europe

Designing our own future

A Chatham House Commission Report



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The Chatham House Commission Report on
Europe after Fifty: Policy Implications for Britain

Chair: Sir Stephen Wall



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Foreword

‘We won’t make a drama out of a crisis,’ said the insurance adverts. In the European Union we apply a different prescription: we like to make a crisis out of a drama.

The vote by the Irish people on the Lisbon Treaty was a drama. It need not be a crisis. The European Union is fifty. It lives well by its founding treaty, the Treaty of Rome, by the Single European Act which created the Single Market and by the Maastricht Treaty which created the single currency. The changes wrought by the largely forgotten Amsterdam Treaty and the much maligned Nice Treaty have proved perfectly workable. Life will go on.

This report is not about treaties but about policies. It is what we – a group of people from Britain and beyond who have been intimately involved in the life of the European Union – think will be the policy challenges for Britain in the next couple of decades. And it looks at the part the European Union has to play in tackling them. We are not dispassionate but we hope we are objective. We have made no bones about focusing on some key areas: foreign and defence policy, energy and climate change, and cooperation in making the world a safer place in terms of combating crime and terrorism.

When British Foreign Secretary Harold Macmillan was invited to attend the Messina Conference which negotiated the Treaty of Rome, he instructed his Foreign Officials to explain that he was too busy – dealing with Cyprus. It was a bad judgment call, but it was not a lie. For much of the four decades that followed the Second World War, succes-

sive British governments wrestled with economic ‘stagflation’ at home, with the threat of nuclear war, and with the fall-out of empire: Cyprus, South Africa, Rhodesia, Gibraltar, the Falklands and Hong Kong.

It was the realization that Britain’s place in the world could only be assured as a member of a wider regional grouping that led Britain to seek membership of the European Community. Then, it was thought that our combined strength could help determine the economic and political shape of the world. We were not far wrong. The EU never was and never will be a superpower but it remains an economic giant and its political influence has been huge: an organization that started with six members and now has 27 is one that has exercised magnetic political, as well as economic, attraction.

In the last half-century the biggest changes have been not just the end of the Soviet empire and the evolution of global networks, but the complex interrelationship between what we used to think of as the domestic and the foreign. Our foreign policy is what we think, say and do about peace and security. But the ingredients of that peace and security, for Europeans, consist primarily of what we say and do about issues such as development, trade, energy security, climate change and migration, how we try to fit our shared interest into common policies and how we mobilize our common policies in the interest of wider peace, prosperity and justice.

In this report we have not delved behind the woodwork of the British debate about our place in the European Union. We have, instead, tried to analyse how best the British interest can be safeguarded and promoted. If we conclude that we can best do it by working with those of our neighbours who share our political values, and with whom we already work in a framework of common policies and law, that is a conclusion driven by hard logic, not soft love.

Sir Stephen Wall

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Preface and acknowledgments

Chatham House has periodically undertaken a major study of the state of the European Union and Britain's position within it, most recently, in 1997, *An Equal Partner: Britain's Role in a Changing Europe. Final Report on the Commission on Britain and Europe*. The year in which the EU celebrated its 50th anniversary, 2007, appeared to be a propitious time to review once again Britain's relationship with the Union, but not simply to mark this important anniversary. Two other more structural factors drove the launch of the study. The first was the need to assess from a British perspective how the strategic purpose of the EU has changed since the end of the Cold War and the EU's subsequent enlargement to 27 member states. How should Britain think about its relationship with the Union within this new strategic context? The second factor was the way in which challenges emanating from beyond Europe's borders – from growing global economic competition to climate change – are increasingly defining the contours of future European integration and activity. How important will coordination with the EU be in helping Britain confront these challenges, and what specific ideas and approaches might Britain bring to future EU policy in particular areas?

We decided that the best way to address such a broad set of questions was to convene a Commission on 'Europe after Fifty: Policy Implications for Britain', whose members would bring to the study a combination of different areas of individual expertise and experience on the European Union. Eleven of the fourteen Commission members are British. However, we also included four non-British

perspectives in order to encourage a more rounded discussion of British policy options and how they might be received in other European capitals.

This is a Commission report, therefore, written with Commission members' direct input and bringing together in one document their collective, if not their specific views on the topics that they chose to address. My thanks go first to the members of the Commission, who gave so much of their time over the course of the study. Their names are listed opposite. Commission members participated in a series of five one-day or half-day meetings starting in September 2007 to discuss the contents of the report. A number of them offered opening papers for the meetings whose ideas were then incorporated in the report. All Commission members provided substantive content, data and amendments to the text as it was elaborated over the following months.

Secondly, I would like to thank Sir Stephen Wall, who chaired the Commission. Stephen worked with us from the outset to define the scope of the overall study and played a central role in pulling the various ideas and policy perspectives together into the final report. His combination of first-hand knowledge of the inner workings of the EU and of British policy-making towards the EU was invaluable to the study.

Thirdly, on behalf of Chatham House, I would like to express our deep gratitude to the Trustees of the Nuffield Foundation who agreed to support the study in the autumn of 2007 with a very generous grant and who made some important early suggestions as to the study approach. We hope that this report does justice to the confidence which they placed in us.

I would also like to thank our colleagues in a number of institutes across Europe who joined us for a workshop in June 2007 as we were preparing the study. They contributed a range of non-British views on the future of Europe and European integration which were very helpful to the overall direction of the study. The participants in the workshop are listed in the Appendix.

This report would not have been possible without the contributions of a number of Chatham House staff, to whom I am very grateful. Robin Shepherd, Senior Research Fellow, acted as rapporteur for the Commission

meetings and provided outlines for a number of the subsequent sections of the report. Anna Dorant-Hayes, my Executive Assistant, took charge of managing the participation and input of the Commission members in the study, both logistically and substantively. Nina Assauer, Europe Programme Coordinator, provided vital research assistance across a range of complex topics and sources. Margaret May, the Head of Publications, did her usual splendid job editing and overseeing the publication process.

Finally, I should also thank Sir Brian Crowe, Deputy Chairman of the Chatham House Council, for his very helpful comments on the section on foreign and security

policy, and Christian Krappitz at the European Commission Delegation in London for his important insights into the state of play of EU integration in the area of justice and home affairs.

All in all, the production of this report underscores the capacity that Chatham House possesses to combine the talents of its staff with the outside intellectual resources we can draw upon to think creatively about the future of significant dimensions of international policy.

Robin Niblett

Director, Chatham House

September 2008

Executive summary

Fifty years after the founding of the European Community, an enlarged EU has moved far away from the notions of creating some form of European super-state that have dominated the British debate over its EU policy. If anything, as the results of recent referenda on the EU in France, the Netherlands and Ireland have revealed, British scepticism towards complex institutional reforms is increasingly shared across Europe. Far from taking advantage of this pivotal moment to help drive the EU's future development, much of the popular and political debate in Britain questions whether it is worth being a member of the EU at all.

This report takes a different approach. It considers the extent to which Britain's membership of the EU can help it pursue its national interests within a rapidly evolving world. It contains a British agenda for Europe that could enable this and future British governments to design outcomes that promote British prosperity and security as well as those of its EU partners, and not just respond reactively to outside pressures.

Our agenda is built upon five central conclusions.

First, Britain's ability to deal with the principal external challenges of the twenty-first century will depend on its active participation in effective EU policies.

Confronting the dangers of climate change, managing an increasingly assertive Russia and the rise of an increasingly powerful China, negotiating with Iran and helping promote peace in the Middle East are all areas where British interests will have their best chance of success as part of strategic EU policies.

EU external policies are likely to be effective only if they reflect shared political will on the part of EU members. And intergovernmentalism will remain at the heart of EU foreign and security policy.

However, Britain should support practical institutional adaptations to improve external EU coordination and action. These include the creation of some version of the proposed European External Action Service and the establishment of an EU headquarters which could draw together the EU's military and non-military assets for conflict prevention and peace-keeping.

Second, Britain should continue to argue the case for further EU enlargement to its east as a strategic priority that will expand the zone of democratic governance and open economies to other European countries.

In this context, the enlargement process into the western Balkans should be accelerated.

There is an especially compelling strategic case for developing as soon as possible a formal pathway that could lead to enlargement negotiations with Ukraine.

The EU should explore a similar approach for Georgia and other countries of the Caucasus, provided they demonstrate their full commitment to democratic norms, an open economy and the ability to take on the EU's legal structure.

Britain must also ensure that the EU remains true to its commitment to work towards Turkey's full EU membership. Britain and the EU would have much to gain at a strategic level from Turkey's entry into the EU, including its roles in helping strengthen the Black Sea region and as an alternative oil and gas transit country into the EU.

Third, Britain will enhance its domestic security against international terrorist and criminal threats by working more closely with EU member states and institutions in the area of justice and home affairs (JHA).

The island mentality which dominates the British debate on domestic security disregards the increasingly mobile nature of twenty-first-century threats. Confronting a terror plot aimed at London but coordinated in Frankfurt and Calais requires Europe-wide structures and procedures for judicial, police and counter-terrorism cooperation.

Britain's arrangement to be able to opt in or out of current formal EU procedures in this area allows it the flexibility to pick and choose its areas of cooperation. In the future, however, there is the real risk that Britain will be excluded from certain enhanced areas of EU cooperation, as it is currently from the Schengen Information System.

The British government should commission regular, annual, independent audits of the performance of EU measures in the JHA area. Members of Parliament must recognize that there will be times where concerns for the exercise of national sovereignty will be outweighed by the judicial and operational benefits of full integration into specific areas of EU action.

Fourth, at a time when the British economy is once again demonstrating systemic weaknesses, the benefits of creating an ever more open and dynamic EU market will increase.

Britain has benefited enormously from its championing of the removal of barriers to intra-EU trade and investment. With short-term protectionist pressures on the rise inside and outside the EU, Britain must remain in the vanguard of promoting EU market deregulation, especially in the area of services.

The British government should also guard against efforts to harmonize national economic policies across the EU which are designed primarily to protect the budgetary and social status quo of other member states. The future strength of the EU will come from the interaction of its different national systems of microeconomic governance that are each exposed to the pressures of national democratic politics and global economic competition.

Britain has not suffered from its decision not to join the euro at its inception in 1999. In the coming years, however, Britain might experience new repercussions from this decision.

The pound and the British economy are increasingly vulnerable to volatility induced by competition between the world's two major currencies – the dollar and the euro. And the extension of euro membership to the vast majority of EU member states in future years will mean Britain is excluded in practice from deeper intra-EU economic consultation and

coordination, including in areas of significant national interest such as financial market regulation.

We are concerned, therefore, that the question of Britain's potential future membership of the euro has become all but invisible. The British government should keep the decision of whether or not to join the single currency under regular and public review.

Fifth, Britain should push for the development of the sort of EU-wide energy market which would benefit its own economy, those of its EU counterparts and their collective commitments to combating climate change.

Britain's energy picture will change radically over the coming two decades, as supplies of British North Sea oil and gas decline. Increased imports of gas will meet Britain's marginal increased energy needs and the bulk of this gas will have to come from Russia.

The government's priority should be to help create a more physically interconnected and integrated EU energy market. This would lessen British and other EU countries' vulnerability to supply disruptions and also deliver considerable efficiency gains.

In addition, the EU should establish a European Energy Agency that would, among other priorities, share information on future European energy needs, plan the physical interconnection of grids and promote the setting of common transmission standards and the financing of storage projects.

Finally, Britain should promote the idea of developing a common EU external energy policy. Under such a policy and operating on a mandate from the member states, the European Commission could negotiate the terms under which external energy suppliers to the EU, such as Russia, would secure access to EU import markets.

The sterility of the debate about Europe in Britain as well as the current institutional uncertainty about the future of the EU are obscuring what an important time this is for British political parties to think strategically about their agenda for Europe. Collective EU responses in the areas we have described can enable Britain and its EU counterparts to tackle some of the most significant risks emerging from beyond Europe's borders.

Introduction

Leaders of the European Union (EU) have been thrown into turmoil once again by Irish voters' rejection of the Lisbon Treaty on 13 June 2008. This comes just three years after the French and Dutch popular rejection of the Constitutional Treaty, its somewhat more ambitious predecessor. The concerns expressed by these votes cannot be ignored. A wide divide clearly persists between the vision of EU leaders on how best to adapt an enlarged EU to deal with current and future global challenges and the popular perception that the EU is remote and incomprehensible.

The need to look forward

It is unclear how EU leaders will proceed over the coming months. They must take into account those popular concerns even as they remain convinced of the need to adjust EU decision-making to help an EU of 27 member states work more effectively together. As members of a Commission convened by Chatham House over the past nine months to consider Britain's future approach to the EU after its 50th anniversary, we believe that it would be wasteful if Britain were now to fall back into its paralysing and perennial stand-off between Eurosceptic and Euroenthusiastic strawmen about Europe's future. Britain can put forward an important long-term policy agenda for the EU, regardless of the institutional compromises that may or may not be engineered. In this report, we offer an agenda that could help Britain and other European countries design their own future, not just respond to a changing world. Indeed, we believe that such a positive agenda would, if taken up also by other European leaders, demonstrate the

practical relevance of the EU for its citizens and could help restore confidence and trust in the EU more broadly.

There is no doubt in our minds that the EU could be better organized to deal with the challenges of the present and the future. But progress depends most fundamentally on shared political vision and will. Popular support for further EU integration cannot be built upon complex institutional proposals and rhetorical commitments. It must be built upon a record of successful collective action.

‘ Popular support for further EU integration cannot be built upon complex institutional proposals and rhetorical commitments. It must be built upon a record of successful collective action ’

In Britain, the sterility of the debate about Europe has diverted attention from the deep changes that have taken place within the EU during the last four to five years. More importantly, it is distracting British policy-makers from the opportunities that now exist for Britain to work constructively with its EU counterparts to tackle some of the most significant risks to future British prosperity and security that are emerging from beyond Europe's borders. A clear British vision that looks beyond the Lisbon Treaty at the range of risks and possible responses is essential.

A radically changed EU

Today's EU has evolved fundamentally from the club of six continental West European countries which came together more than fifty years ago in the Treaty of Rome to end the cycle of wars between them and to maximize collectively their economic prosperity. Since the collapse of the Berlin Wall in 1989, and the end of the division of Europe between East and West through the EU's enlargement to

27 member states, the EU has had to revisit questions about its central purposes and its future.

On the one hand, the EU is now an economic giant, comprising some 495 million people, with a combined GDP greater than that of the United States. It is one of the most integrated markets in the world, sharing a common currency among more than half of its members, with open internal borders and an increasingly prosperous population. Politically, member state governments have pooled aspects of their sovereignty over market governance, monetary affairs (in the case of Eurozone countries), foreign trade and environmental policy. They have done so within EU institutions through which they make collective decisions on common regulations and rules that can be implemented across the member states.

Despite this central position and its significant influence on the EU's recent development, Britain has been less focused on helping to define the Union's future policies than on debating whether it wants to be part of the EU at all

On the other hand, there is a worrying sense of insecurity and uncertainty among European citizens, visible in the rejection in May and June 2005 of the proposed EU Constitutional Treaty by French and Dutch voters – the electorate of two of the EU's founding members – and now in the Irish referendum result. These votes expose a host of diverse and disconnected concerns about the future of the EU, from the changing balance of power between larger and smaller member states to the EU's ability to help them confront the challenges of globalization and the possible impact of further enlargement.

They also reflect impatience on the part of citizens about the perceived navel-gazing by European elites more concerned with the minutiae of institutional structures than the policies they ought to be pursuing. Many EU

citizens do not see EU integration as the compelling answer to the growing challenges emanating from outside their borders – economic competition from China; immigration from and via North Africa and the world's zones of conflict; energy insecurity; the rise of radical Islam. If anything, the EU's commitment to further enlargement and its dilution of national economic, social and political prerogatives appear to be contributing to a crisis of confidence among significant parts of the European public.

A second opportunity for Britain

Fifty years ago, at a time of similar flux and uncertainty, Britain was distracted from developments in Europe by its desire to hold on to elements of its imperial past, by a difficult ongoing redefinition of its relationship with the United States, and by an inability to comprehend fully the driving forces behind the formation of the EEC. Today, Britain is an integral member of the EU, even if its geography and history often translate into a psychological barrier to making a deeper commitment. It has one of the EU's largest economies and hosts its leading financial centre; it is a central player in the EU's Common Foreign and Security Policy (CFSP); it is a prime mover behind the building of a European Security and Defence Policy (ESDP); it is one of the EU's champions of economic reform and of enlargement; it has one of the closest relationships of any EU member with the United States; and it is at the centre of European debates about the challenges of the future, such as how to respond to the rise of violent forms of radical Islam in Europe's midst and to the pressing dangers of climate change.

Yet, despite this central position and its significant influence on the EU's recent development, Britain has been less focused on helping to define the Union's future policies than on debating whether it wants to be part of the EU at all. Because it lacks the sense of the political imperative that drove together the EU's founding continental members, discussion about Europe in the UK remains largely hostage to caricatures of whether Europe is or is not morphing into a bureaucratic super-state.

It is important to acknowledge that any notions of

creating a European super-state have long since collapsed under the weight of political reality. An EU which comprises such a large and diverse membership makes impossible, both politically and practically, the level of centralization of power within supranational EU institutions in Brussels that a super-state would require.

Driven, therefore, both by the awareness of this rare moment to redefine Britain's relationship with Europe and by our frustration with the sterility of the current national debate, we suggest a different way of approaching the vexed question of Britain's relationship with the European Union. We examine a set of policy areas vital to Britain and ask not how Britain can accommodate them to the European Union but how, to what extent and, indeed, whether the European Union can help Britain to pursue its national interests in these areas, however defined.

Structure of the report

Principally, the report considers Britain's and Europe's place within an evolving world over the next decade or so. By looking to the future rather than the past, we hope to help British policy-makers and opinion-shapers engage in a more constructive dialogue about Britain's approach to the EU with an often sceptical and, more damagingly, uninterested domestic audience. This perspective on the future may go some way to closing the gap between government aspirations and popular attitudes towards the EU.

Section 1 considers what sort of a world Britain will find itself in over the coming years. How directly might Britain be affected by the decline in relative US international influence, the rise of new centres of economic and political power, the growing capacity of non-state actors, the emergence of new transnational challenges such as climate change, and the persistence of regional security risks? How will these changes affect the dynamics of Britain's complex relationships with the United States and with Europe?

The second section explores the increasingly active role the EU is taking on the international stage and how it might become a more coherent international actor in the fields of foreign and security policy. With this in mind, we

ask how Britain can work through the EU to help bring about the kind of world it wants to see, and then discuss five cases where Britain is already involved in developing more proactive EU responses.

In the third section, we examine how Britain might influence one of the EU's most powerful but controversial forces for positive change in the wider world – its enlargement to new members. There is a growing ambivalence about the benefits for existing EU members, including Britain, of further EU enlargement. What is the correct long-term approach to take? Should we define an end-state to EU enlargement that offers a greater degree of certainty to electorates inside the Union, or retain a more flexible perspective for countries that aspire to join?

Section 4 explores how the unsettled world beyond the EU's boundaries is opening up new threats to the domestic security of British and other EU citizens. At one time, Britain's island status was thought to hold back many of these risks. Now, the drivers of globalization – people, ideas, communication, technology, open trade and investment – penetrate barriers which once held the country secure. How far should British laws and practices be adapted to coordinate with European neighbours who face the same growing risks within their own societies?

The fifth section addresses the economy. Membership of the EU has been one of the ways in which medium-sized states such as Britain have coped with the growing competitive pressures from countries with larger domestic markets. The UK has been at the forefront of the EU's efforts to adjust to the need to be open to the opportunities of global economic engagement rather than trying to erect barriers to protect the European economy from outside pressure. This section considers where the British government should lay its emphasis in order to help itself and the EU as a whole to deal with a radically new global economy later this century.

The report then focuses in Section 6 on one specific policy area that straddles each of the preceding topics: the ability to balance the need for secure and sufficient energy at affordable prices with the need to move towards a low-carbon economy. Britain has traditionally been in a unique place in the European energy debate thanks to its large reserves of oil and gas in the North Sea. This advantage

will rapidly erode in the next decade or two, and Britain must make a better effort to prepare for this inevitability. How might the creation of a more integrated and physically inter-connected, cross-border European energy market enhance both the security of supply of British energy and the stability of its price, at the same time as contributing to a rebalancing of energy consumption away from carbon-intensive resources? What hurdles stand in the way?

In each section, we focus on three questions. How are British interests evolving and likely to evolve over the next decade or more? How is the EU changing and what options does Britain's membership of the EU bring in pursuing those interests? And how might Britain adapt its

approach to opportunities that currently exist in the EU or try to adapt the EU to its own vision of meeting the challenges that Britain faces collectively with its EU partners?

Our agenda is not designed to serve one vision of the European Union or another. Setting aside the extremes, supporters of closer British integration with Europe as well as those who take a sceptical view of this process should find here pragmatic ideas to pursue Britain's national interests within the context of the European Union. Not every suggestion will be acceptable to everyone. That is not important. What matters is that this report makes its contribution towards reinvigorating the debate about Europe in Britain and Britain in Europe while providing some concrete policy suggestions along the way.

1. Britain, Europe and a rapidly evolving world

The world Britain is stepping into

Britain's relationship with Europe over the next decade will be affected less by its preconceptions about the pros and cons of European integration and more by the parameters of the new world it is likely to be stepping into. While it is difficult, if not impossible, to foretell some of the big disjunctures which might disrupt the established international order in the coming years, the direction of incremental change will entail fundamental choices about Britain's place in the world and, as a result, for its potential partnership with Europe.

‘ Britain's relationship with Europe over the next decade will be affected less by its preconceptions about the pros and cons of European integration and more by the parameters of the new world it is likely to be stepping into ’

Britain occupied a privileged position within the ‘bipolar’ international system of the Cold War. Despite gradually relinquishing its empire in the two to three

decades after 1945, it retained diplomatic clout and a strong voice within Europe (if not always inside the EU), largely thanks to its role as the closest and most trusted of America's NATO allies, as a nuclear and a significant military power, as a permanent, veto-carrying member of the UN Security Council and as a large, if at times fragile, economy. The strategic priority for Britain during the Cold War was clear – to stand alongside the United States in confronting the Soviet Union, as these two countries engaged in worldwide ideological and regional competition, held in check by nuclear deterrence.

The end of the Cold War has created a far more complex world for Britain. Four facets stand out, in particular: the changing priorities of the United States; the rise of new world powers; the direct impact on British security and prosperity of growing transnational risks such as economic instability and climate change; and the new challenges of the European neighbourhood.

The changing US outlook on the world

The demise of the Soviet Union in 1991 left the United States with unrivalled pre-eminence within the global system. Unfortunately, this led to a sense of hubris among parts of the US political class which has undermined trust in US leadership internationally. The appearance of a United States which could wield power largely unchecked also called into question the singular value to US interests of traditional European allies, including Britain, as was apparent on a number of occasions during both the Clinton and George W. Bush administrations.

America's sense of exceptionalism was compounded by the dramatic terrorist attacks in New York and Washington on 11 September 2001. The notion of protecting the homeland from external threats surged to the fore in US policy-making. For George W. Bush, as for the US presidential candidates now vying to succeed him, the terrorist threat emanates principally from abroad and must be confronted abroad, whether in Afghanistan, Iraq, Yemen or the Philippines. Disparate groups such as Hamas, Hizbollah, the Taliban and Al-Qaeda are often blended into a single terrorist threat to US interests and allies. And Iran's use of proxies for regional advantage in countries including Lebanon, Iraq and Palestine is held up as a

blatant example of state sponsorship of international terrorism that is a direct threat to US security.

The limits of US power in confronting these new security threats became apparent in Iraq and in Afghanistan. In 2005, the Bush administration moved in a more multilateral direction, coordinating better with allies on its policies towards Iran and North Korea, for example. But regardless of who wins the US presidential election in November 2008, the United States is likely to be at once defensive about any loss of its pre-eminent status internationally, focused on protecting itself from the terrorist threat, and, while trying to re-establish its multilateral credentials, still convinced of its leadership role. It will continue to be more inclined than its partners in Europe to protect its interests unilaterally, if necessary by force. This will make it a complex ally for the British government and for others.

The rise of new powers

The second big change is the eclipse of the brief 'unipolar moment' of US global power and the emergence of a group of increasingly self-confident and often competing state powers on the world stage, the most obvious examples being China, India, Russia and Brazil. These countries, along with the EU, will vie for influence in establishing the rules of the game in an economically globalized world and compete to protect their respective security and economic interests. The United States will still be dominant in terms of its ability to project 'hard' military power, and it will continue to exert the 'soft' power of its open society, economic dynamism and image of individual opportunity. International economic and political power, however, will be more evenly distributed.

Member states of the EU will constitute part of this new 'multipolarity' primarily through their national influence upon the collective voice of the EU. This will be true also for Britain and France, even as they retain an enhanced status on certain diplomatic issues through their permanent membership of the UN Security Council, and for Germany which, despite China's rise, remains the world's leading exporter. As China's global reach, economic power and political clout converge on that of the United States, with India next in line, a new outlook will be

needed. It will remain difficult for the EU, with its mixture of intergovernmental and supranational decision-making processes for external action, to be agile and proactive in an increasingly competitive international environment, compared with large states which, whatever their internal tensions, project sovereign self-interest.

The continuing growth of interdependence

Any notion that the world in the twenty-first century will resemble the competitive balance-of-power era of nineteenth-century Europe must be tempered by awareness of the third factor: the growing interdependence between the world's major powers and with the rest of the world as a result of economic, technological and cultural globalization. This shows no signs of abating, despite the recent rise of economic protectionism and anti-immigrant feeling in many countries.

Interdependence offers great opportunities for economic growth and a new stability to the international system. It also presents new risks for the future. Increased economic interdependence goes hand in hand with increased economic specialization by countries that can be vulnerable to sudden changes in competitiveness. Economic globalization also offers avenues for the rapid spread of transnational dangers such as infectious diseases or financial instability. The effects of these and other international challenges, such as climate change or international terrorism, will be more seamlessly transferred from one country or community to another in this globalized world. No government, whether of one of world's major powers, an intermediate power like Britain, or a smaller state, will be able to protect the interests of its citizens on its own.

An uncertain European neighbourhood

The fourth international development that will be especially relevant to Britain will be the prospects for its own European neighbourhood. EU enlargement has extended economic and political stability through much of central and eastern Europe. At the same time, the EU's borders now reach parts of the world that have to date been at a distance from its influence, many of which are unlikely to be offered the transformative prospect of future EU membership. An

arc of potential instability runs from North Africa, up through the eastern rim of the Mediterranean to the Caucasus and into parts of the Black Sea region. And Russia stands as an increasingly unpredictable neighbour to Europe's east. In addition, the enlarged EU's porous borders and inadequately coordinated law enforcement agencies increase the risk that threats which emanate from, and transit through, the EU's neighbourhood could more easily penetrate into Britain. These could take the form of organized crime, drug-trafficking, proliferation of weapons

‘ No government, whether of one of world's major powers, an intermediate power like Britain, or a smaller state, will be able to protect the interests of its citizens on its own ’

of mass destruction (WMD), illegal migration or terrorism.

As during the Cold War, Britain cannot protect itself from external risks nor pursue all of its foreign policy priorities alone. International institutions such as the UN and NATO will continue to offer important venues for furthering the interests of Britain and its allies. But this is also a critical moment to consider how membership of the EU – an entity that represents a qualitatively deeper form of international integration – could enable Britain to protect and further its interests alongside those of its EU partners in the wider world.

The specific British context: between Europe and the United States

Past and present British reservations about working with EU partners or institutions on issues of foreign and security policy have often been a corollary of a preference for working with the United States. We must consider, therefore, how the changes in the US strategic position described above might affect US–UK relations and coop-

eration in the future. Our overall conclusion is that the relationship is unlikely to recover the political closeness of much of the Cold War and immediate post-Cold War periods.

A more fluid US–UK relationship

Our conclusion does not underestimate the great value to both countries of the unique levels of US–UK cooperation in the nuclear, military and intelligence fields, which should continue well into the future. Nor is it based upon the decline of British public support for US global leadership since 2003, although the data here are revealing and will affect the room for manoeuvre of future British governments.¹ Nor does it negate the fact that Britain and the United States are likely to find themselves confronting similar global problems in the future and will generally look to each other for support.

But, however common the interests and however close the relations between leaders and senior officials in both countries, British governments will find in the future a US ally that differentiates quite clearly between individual European countries in terms of how they can help the United States achieve its diverse international objectives. While Britain might have a pre-eminent position in dealing with the situation in Afghanistan, for example, German support for the extension of stability into eastern Europe or in drawing Russia westwards will continue to be indispensable from a US perspective. And while UK officials are likely to continue to gain privileged access to the halls of power in Washington, they will be just one more voice in the inter-agency competition for presidential attention.

A further important element in the future US–UK relationship will be the way in which international terrorism, as a central preoccupation for the United States, creates a different calculus of risks and rewards for US leaders as compared with their British or other European counterparts. The latter stood firmly beside the United States in their response in Afghanistan to the 9/11 attacks, and Britain was an ally from the start in Iraq. But the two countries approach and think about the terrorist problem from significantly different vantage points. The United States concentrates on the external threat and seeks to

protect its homeland from terrorists at and beyond its borders. British leaders are especially conscious after the attacks of July 2005 that the terrorist threat is both internal and external, and that winning the battle of values and ideas within elements of British society and those of radicalized states around the world is just as important as counter-terrorism measures.

Converging British and European external priorities

At the same time, for a number of reasons British thinking on many of the international challenges of the next decade will evolve closer to its EU partners' views than to those of the United States. To start with, whereas Europe and its immediate neighbourhood will become an area of diminishing strategic interest to the United States, Britain, like other EU members, will spend a large amount of its diplomatic energy on questions arising from this area – from Russian policy towards central and eastern Europe to continuing tensions in the Balkans.

This is partly a matter of geography. The new transnational risks for Britain are seeping in from Europe's periphery, whether these be migration from impoverished countries in sub-Saharan Africa or the trafficking of illicit goods from the former Soviet Union. Britain is as vulnerable as its EU partners to the problems around the periphery of Europe.

Beyond this periphery the picture is similar. Unlike the United States, Britain long shared the view of its EU partners that direct negotiations with Iran are an indispensable component of the approach to controlling its nuclear enrichment programme. British governments have consistently espoused what Tony Blair called an 'even-handed' approach to the Arab-Israeli question, reflecting the EU consensus on this question, a consensus that does not stretch to Washington. The British government has endorsed EU efforts to develop a 'strategic partnership' with China and did not initially object to the decision to lift the EU arms embargo as part of this process. US

decision-makers, for their part, take a more sceptical view of China's rise, especially in the security field. And Britain has been a leading proponent of the EU's efforts to negotiate an ambitious global agreement on tackling climate change whose institutional dimensions are likely to exceed those envisaged in even the most positive US approach.

‘British thinking on many of the international challenges of the next decade will evolve closer to its EU partners' views than to those of the United States’

The difference between the British and the US global outlook is partly a matter of size. In a multipolar world, the United States is one among other big powers. Britain, like other EU countries and despite its position on the UN Security Council, cannot pretend to be self-sufficient or able to fix problems by itself. In addition, its relationship with its European partners is one either of equality or of being one of the more powerful member states. Whatever the nature of the 'special relationship', Britain is very much the junior partner in its dealings with the United States.

In coming years, therefore, British governments can no longer assume that their international policies should be coordinated first in Washington and then sold to their European partners. Nor should Britain start by trying to serve as a bridge between differing US and European approaches. It should treat the need to develop a common approach with key European partners on major foreign or security policy challenges as, at the very least, an equal priority to that of engaging the United States, if necessary, on joint or coordinated EU-US action.

2. Developing more proactive and coherent European foreign and security policies

The adjustment to its relationship with the United States raises the question of how Britain should approach the future development of foreign and security policy-making within the EU. The central question is this: even if Britain is dealing with equals in the European Union and even if it shares the bulk of external challenges with them, can the EU emerge as a serious player on the international stage and so further the collective interests of its members?

European foreign and security policy: a mixed but growing record

The internal divisions in the EU over supporting the US stance on Iraq in 2002–03, the continuing disagreements over how to handle Russia's growing assertiveness, and tensions over military burden-sharing in Afghanistan are all important recent reminders of the difficulty in achieving European consensus on action in the face of controversial foreign policy issues. The external interests of individual EU governments vary across the Union, reflecting historical experience, ethnic connections, geopolitical considerations, economic self-interest and

diverse national capabilities to act. This diversity would only increase with further expansion of EU membership.

However, this is not a static situation. EU member states have developed deep-seated habits of consultation on foreign policy over the last 25 years. Whether in the Middle East, Africa or Asia, Britain and other EU members have sought to meld the political and economic capabilities of the EU and its members into collective leverage which combines the carrots of development assistance and EU market access with the sticks of diplomatic pressure, military deployment and economic sanctions.

Africa stands out as a specific example. Since the end of the Cold War, former colonial powers have sought to overcome local resistance by involving EU partners and the EU itself in order to combine aid, trade and immigration policies and strategies of civilian or military intervention to deal with civil wars and general instability. The emergence of the African Union has generated an obvious partner for the EU in this context, and the recent opening of an EU 'embassy' in Addis Ababa, which hosts the AU headquarters, demonstrates the importance of Africa for the EU's Common Foreign and Security Policy.²

At the same time, the EU is engaged in negotiating and implementing an extensive range of trade and partnership agreements with the major new world powers, China, India, Brazil and Russia, as well as with other countries in Latin America and East Asia. These agreements reach beyond questions of market access to cover broader political and security issues, such as human rights, energy policy, environmental protection, non-proliferation and counter-terrorism. Although bilateral relations remain critical for EU members in all regions, there is a growing awareness of the value of operating collectively through the EU, and also a growing demand for this, reflected in the many regional summits now taking place each year under EU auspices.

The pressures for deepening EU cooperation on foreign and security policy will only increase over the next decade. All EU member states, including Britain, face broadly the same risks, even if with different levels of intensity. These include energy security (involving Russia in particular); illegal migratory flows; residual insecurity around Europe's 'near abroad'; instability and threats to international

security and oil supplies in the Middle East; climate change and environmental pressures; Al-Qaeda-inspired terrorism, both at home and from abroad; and nuclear proliferation. None of these challenges can be taken up successfully by Britain on its own. But they could be addressed if British interests are reflected within a more capable and influential EU.

‘That the EU is not always as united or strong as it needs to be should serve as an incentive for Britain to try to strengthen EU external policy-making’

Therefore, the fact that the EU is not always as united or strong as it needs to be should serve as an incentive for Britain to try to strengthen EU external policy-making and make it more agile and coherent, not to complain that it is intrinsically ineffective.

Improving the capacity for EU decision-taking and follow-through

Members of this Commission do not envisage achieving this by transferring foreign policy-making of the type concerned with major questions of international security from the intergovernmental to the Community method of decision-making, with its provisions for qualified majority voting, the right of initiative for the Commission, co-decision with the European Parliament and jurisdiction by the European Court of Justice. This is not politically feasible in an EU of nationally elected governments, all of which wish to retain sovereign choices in matters that affect national security.

But scepticism about an expansion of ‘Community competence’ in this field does not preclude Britain from helping to strengthen the processes that will enable it and its EU partners to work more effectively together on the international stage.

The Lisbon Treaty contains some important innovations in this area. While not removing the sovereign prerogative of EU member states to abstain from EU external actions, they would enable those who want to act to do so more effectively than at present. For example, combining the positions of the EU’s High Representative for CFSP and the Commissioner for External Relations into a single, combined High Representative would contribute to bringing together the economic, diplomatic and security tools of the EU in its external policy – a critical dimension of collective EU influence as compared with national capabilities. This adaptation needs treaty changes and so could not proceed in the absence of the Lisbon Treaty or a similar agreement.

A European External Action Service

However, the British government could support other specific, practical steps to achieve greater coherence in EU foreign policy-making should the entry into force of the Lisbon Treaty prove impossible. Among them, Britain should continue to support the creation of some version of the European External Action Service (EEAS), an important innovation of the Lisbon Treaty.³ This could not be the service envisaged in the Lisbon Treaty, since, without that treaty, the Commissioner for External Relations and the High Representative for the CFSP would continue to remain separate and would need their own support staffs in Brussels. But it is still possible to go some way towards bridging differences and achieving greater synergies between the European Commission and national interests and initiatives within EU external policies.

- In third countries, for example, there is no reason why the European Commission’s existing delegations (nearly 130 of them) should not start to include staff from the Council Secretariat and national diplomats (as envisaged in the Lisbon Treaty) as well as from the European Commission. These national diplomats and Council staff could report to both the Commission and the High Representative.

This intermediate step would not require a treaty change and could be achieved by inter-institutional agreement.

While it might make aspects of the work of some national embassies redundant, it would be up to individual national governments to arrive at that decision. The central point is that more capable and better-integrated EU delegations would, at the very least, improve the chances of implementing agreed EU foreign and security policies effectively around the world.

It must be accepted, however, that no new formal EU decision-making processes will, in themselves, create the political will for EU members to act together proactively to achieve their collective goals. What additional options exist, therefore, for improving the dynamism of EU external action?

Core groups of countries

Britain should be a strong proponent of an understanding that individual EU member states would not block the desire of a clear majority of other member states to act internationally using the mandate and clout of the EU, unless they had an overriding national interest to do so.

- In this context, we recognize and support the emergence of core groups of member states that together take a leadership role on behalf of and in coordination with the EU for those external issues that are of greatest importance to them.

Core groups will form most naturally around policy areas in which EU countries feel they have a greater stake than others. Poland, Germany and the Baltic states, for instance, have tended to lead the way in relations with Ukraine and Belarus, pushing the EU towards more constructive forms of engagement with the two countries. Given the UN Security Council roles of Britain and France, and Germany's economic importance, these three countries have grouped together (as the 'EU-3') to take the lead on the Iranian nuclear issue. France, Spain and Italy have taken leading roles in encouraging closer EU relations with the countries around the southern rim of the Mediterranean. Greece, Romania and Bulgaria will play critical roles in the development of the Black Sea region.

In each case, different groups of countries, small and large, might act as an EU core group, although it would

generally make sense for at least one large member state (not only the EU-3 but also states such as Italy, Poland or Spain) to be engaged both in terms of diplomatic capacity and to assist intra-EU coordination for the sake of a common policy.

If this approach is to succeed, however, a rigorous effort is needed to ensure that the EU as a whole is consulted on the particular topic and, most importantly, on any proposals that might be made on behalf of the EU as a whole. In this context, the legitimacy of these groups and their ability to act for the EU will require that the High Representative should participate, and indeed, as over Iran, be given the lead in negotiating for the EU with third parties. The European Commission will also need to be closely involved where part or all of the implementation of any agreement falls within its areas of competence.

Improving EU defence capabilities

One other dimension will be indispensable if the EU is to be a more effective actor and influential vehicle for its members' interests in the coming years – its defence policies and capabilities.

The record, while modest, shows clear signs of becoming increasingly serious. Since 2003, the EU has been engaged via the European Security and Defence Policy in more than twenty missions on three continents, including current military missions in Bosnia and Herzegovina (EUFOR-Althea) and in Eastern Chad and the northeast of the Central African Republic (EUFOR-TCHAD/RCA). Small ESDP police operations are under way in Bosnia and Herzegovina, the occupied Palestinian territory, Afghanistan and the Democratic Republic of Congo. These do not include the more substantial numbers of European national contingents in NATO's ISAF operation in Afghanistan and KFOR operation in Kosovo, or the UNIFIL operation in Southern Lebanon.⁴

But current levels of defence capability across the EU are inadequate to meet both the long-term ambitions and needs of the EU for the roles laid out in the 2003 European Security Strategy. This includes investment shortfalls in capabilities critical for future EU missions, such as strategic and tactical air-lift, helicopters and

command and control systems, as well as infantry available for peace-keeping operations. The fact that many EU nations continue to retain military forces better designed for territorial defence than for outside deployment does not reflect the actual threats to EU security. This carries serious implications for Britain in the future. The divergences in national EU military capabilities, investments and willingness to use force in foreign policy are translating into intra-EU divergences over actual foreign policy choices. These could leave countries such as Britain carrying an unacceptable proportion of the military burden and public expenditure costs of overall European security in the future.

‘ Helping establish an EU headquarters which combines the EU’s military and non-military assets should now be a British as well as a French and EU priority ’

Britain has been one of the leading contributors to NATO capabilities and was also a leading proponent of ESDP in the St Malo agreement between Tony Blair and Jacques Chirac in 1998. Today, irrespective of whether the Lisbon Treaty comes into force, Britain has the opportunity to help strengthen EU coordination of its security and defence policy. President Sarkozy’s declared willingness to bring France back into the NATO integrated military structure after an absence of forty years, and the recently announced reforms in the structure of the French armed forces, offer a significant opportunity for it and Britain to lessen the continuing frictions between NATO and ESDP and improve the ability of both to operate together effectively around the world.

British nervousness persists, however, that a French proposal for separate headquarters for EU military operations would duplicate what is available through NATO and national headquarters. Interestingly, in the United States both Republican and Democratic policy-makers are not

only far less ideologically opposed now to ESDP as a potential spoiler of NATO, they actively support it as a means of bringing the EU and NATO closer together. They recognize that, for some roles, such as nation-building and peace-keeping, the EU might be preferable to NATO.

- Given this new context, Britain should give up its traditional reservations about a separate EU operational planning capability for ESDP, while working to ensure that its size matches its modest current ambitions, that it is still able to draw on NATO and that it makes the most of the EU’s civilian ESDP capability in combined military and civil-military operations. The EU does not have to invest in as large or elaborate a command infrastructure or integrated military command as NATO in order to be effective. But helping establish an EU headquarters which combines the EU’s military and non-military assets should now be a British as well as a French and EU priority.

It is important to be clear here. With or without the Lisbon Treaty, national EU governments will retain full control of their defence deployments and engagements. Moreover, the military forces they earmark for or assign to the EU for particular operations will draw on the same pool of national forces as member states earmark for NATO operations and should be able to perform the same kind of operations. The one difference will be that, in NATO operations, the United States is likely to be involved, given its overwhelming military capacity. This could lead to a practical division: NATO for larger-scale operations and the EU for smaller ones in which the United States does not want to be engaged.

But there should be no difference of principle. The EU is developing an additional and different capacity which NATO does not have: not only military forces, but including ‘rule of law’ and ‘gendarmierie’-type operations, that together emphasize civil-military synergies, engage primarily in post-conflict crisis management and peace-keeping, and support state-building as well as humanitarian interventions alongside aid and development missions.

Areas for action

The international challenges to British interests over the next ten to twenty years are myriad. In the context of the procedural steps outlined above, we focus on five issues that illustrate the potential for collective EU action. We recognize, of course, that there are many other issues that could also benefit from closer EU coordination from a British perspective. The first of the five is climate change – a truly global challenge which requires not only a coherent EU lead within Europe, but also an EU lead within complex international negotiations towards a global deal. The remaining four are more traditional challenges which concern specific countries – China, the Arab-Israeli conflict, Iran and Russia – and their regional impacts on British and European interests.

1. CONFRONTING CLIMATE CHANGE

Combating climate change is already high on the EU agenda, championed strongly by the British and other governments and in the recent Stern Report. If global warming does continue in the way that most scientists believe it will, it could have devastating effects globally. Europe will not be immune from these effects which will include floods, famine and the risk that millions of desperate people from African and Middle Eastern countries will seek refuge in the cooler climes of a more prosperous Europe.

European and global climate security requires global agreement to minimize the probability of an overall average rise of 2°C over pre-industrial levels. Going beyond this level presents unacceptable risks of passing ‘climatic tipping points’, at which stage damage may be irreversible and the ability to control the extent of further temperature rises may be lost. It is argued that to give a 50/50 chance of staying within the 2°C limit, global CO₂ emissions will need to peak in the next two decades and fall by over 50% by 2050. For the European Union and other developed countries this implies moving to an essentially carbon-neutral economy by around 2050, with major developing countries following suit well before the end of the century. All major emitting countries will need to begin radical decarbonization in the next 20 years, whatever their level of development.⁵

Delivering these ambitious goals will require realistic and focused efforts to secure an effective global climate change agreement in Copenhagen in December 2009. The

measure of this agreement will not be just whether it gains acceptance by all major emitting countries, but whether it generates a transformational shift in international energy finance flows – moving the \$21 trillion of energy investment forecast to occur by 2030 from high-carbon to low-carbon technologies.⁶

Currently, the political conditions to deliver a global deal do not exist. China and India need continued high levels of economic growth to bring much of their populations out of poverty and, in China’s case, to prevent political instability. The United States is still some way from showing the kind of domestic and international leadership on this issue that might in turn favourably influence China and India. Even taking into account the arrival of a new US president who is more committed to combating climate change, as is the case with Senators McCain and Obama, powerful leadership will be needed to build the politics for a meaningful global climate change consensus.

The EU’s unilateral commitment in March 2007 to reduce greenhouse gas (GHG) emissions by 20% by 2020 was an important statement of intent that now needs to be implemented. The EU recognizes that it must be part of a larger international agreement and will only make a real impact if accompanied by similar reductions by other major emitters such as China, India and the United States. Under these conditions, the EU has promised to reduce its emissions even more – by 30% by 2020, which is more in line with the scientific reductions requirement of the 2°C commitment.

EU efforts to encourage convergence between the very different perspectives of these three key players will remain critical.

- The EU is the first major emitter to commit to an early shift to decarbonization. European commitments have been crucial in forming expectations in global business that action on climate change will happen and will create real markets. Higher levels of ambition and earlier commitment to decarbonization in the United States, China and India are only likely to materialize if Europe delivers. Put differently, the future cannot afford to see Europe – the only credible standard-bearer – fail in meeting its own climate objectives.
- The financing, development and deployment of new technologies will be a key pillar of the global deal that must be agreed in Copenhagen. The EU has a vital role to play in ensuring that a substantial fund for this purpose is established.
- Britain has argued consistently for ambitious targets and has encouraged European institutions to take on the necessary regulatory role. It should continue to argue for far-sighted and radical leadership by the EU as a whole, but British leaders should recognize that their influence will be undermined if Britain continues to fail to meet its own national targets.⁷

European commitments have been crucial in forming expectations in global business that action on climate change will happen and will create real markets

Accompanying the GHG target are proposals on improving energy efficiency, targets for renewable energy and plans to establish the framework for an expansion of the EU Emissions Trading Scheme. The EU's objective on both energy efficiency and renewables are extremely ambitious, requiring that by 2020 there is a 20% increase in energy efficiency and that 20% of the energy is met from renewable sources. The former objective is predicted to result in annual

energy bill savings of over €100 billion per year by 2020 and, once and for all, to break the linkage between energy consumption and GDP growth.⁸

Without the more efficient use of energy it will be impossible to create a secure and sustainable system. If energy demand continues to rise, Britain and other EU countries will have to rely on more and more energy imports and will not meet their emissions reductions targets. The options to make a meaningful impact in terms of combating climate change exist and much rests on the EU's collective ability to make reality match the rhetoric.

2. CHINA

The economic dimension of the relationship between China and the EU and its individual member states has tended to be dominant in recent years. In 2007 two-way trade topped €300 billion, and the EU was China's largest trading partner. In April 2008, a new 'high-level mechanism' was created – a six-monthly gathering of EU Commissioners and Chinese ministers designed to overcome disputes on trade and investment. The importance of this dialogue will only increase as the EU trading deficit with China continues to grow and Chinese protectionism begets a growing protectionist backlash across the EU.

China's rise carries implications far beyond the economic, however, and Britain should be among those countries helping the EU develop a truly strategic but realistic relationship with China. The announcement of a new 'strategic partnership' between the EU and China in a European Commission paper in 2003 and the institution of senior-level summits at the vice-ministerial level from 2005 have demonstrated a growing appreciation of how each side could affect the broader international goals of the other, from combating the spread of infectious disease to discussing development strategies and conflict resolution in Africa to joint programmes to confront climate change.⁹

Nevertheless, the EU has paid little attention to the Asia-wide security implications of China's rise, despite the important differences in political values and governance that each side brings to the table. Looking to the future, Britain, working with other EU states that have the closest relations

with China – not only France and Germany but also Italy and the Netherlands, for example – should complement the growing EU–China strategic dialogue with a more comprehensive EU perspective on the dynamics of East Asian security.

The new US administration will, like others before it, develop a strategy towards China that is based largely on bilateral considerations, including US–Chinese economic relations, the US–Japan alliance, negotiations with North Korea, and the situation in Taiwan. These considerations will have little to do with Europe, including Britain. The risk is that the EU will continue to see China primarily as an economic challenge, despite the fact that in East Asia the security architecture remains in flux and a rise in security tensions could have very negative global consequences. Britain and its EU partners should enter into deeper security dialogues with China, including military-to-military cooperation and exercises. At the same time, they should also enhance their bilateral strategic relations with other countries in the region, including Japan and South Korea.

Finally, Britain should also look for ways to bring all three actors – the EU, China and the United States – together into regular discussions on common international challenges in order to strengthen this trilateral relationship which is so vital to the global economy, but also, potentially, to international security. Such dialogue is most urgently needed to align their divergent approaches and to take specific, coordinated action to tackle climate change and its expected effects.

3. DEALING WITH THE ARAB-ISRAELI CONFLICT

The primary role played by the EU as a whole, as well as by Britain and its individual EU partners in addressing the Israel-Palestine conflict, has been in providing assistance to alleviate the humanitarian situation and to improve the economic opportunities for the Palestinian people. The EU is now by far the largest provider of funds to the Palestinian Authority, with EU assistance alone (apart from national EU contributions) averaging €260 million annually since the outbreak of the second intifada in 2000.¹⁰ The EU is one part of the Quartet (comprising the United States, Russia, the UN and the EU), which oversees

the ‘peace process’ that is meant to help resolve the conflict, though its influence has declined in recent years. The EU also has considerably deepened its economic relationship with Israel in recent years, and is already the country’s largest trading and investment partner by a long way. How to use its economic leverage to support commitments made by Israel in the context of the ongoing peace negotiations with the Palestinian Authority will be a difficult but important consideration for the EU.

- It is clear, however, that the instruments of economic leverage alone will be insufficient to overcome the deep-rooted confrontation between Palestinians and Israelis. Even though a breakthrough in the peace negotiations is unlikely to happen soon, Britain and other EU countries should start thinking now what they would bring to the table in terms of security guarantees for both sides in the context of a negotiated solution that involves the pull-back of Israeli security forces from the West Bank.

Which countries, what capabilities and what commitments would be fraught decisions for the EU. And, without the building of closer relations between the EU and Israel, it will also be a theoretical dialogue. Over the coming years, EU members and the EU itself need to develop closer relations with the Israeli Defence Forces, and effective European leadership of UN forces in and off the coast of Lebanon will be a crucial test for this relationship. However these options play out, Britain’s chances of having a positive effect on this conflict, which is so central to regional security and of intense domestic interest, will be all the more credible if it is playing a leading role in the development and implementation of EU strategies alongside its other policy avenues in Washington, New York and the region itself.

4. NEGOTIATING WITH IRAN

Dealing with Iran is a further area where British interests demand joint efforts with European partners in order to have impact. Iran presents one of the clearest risks in terms of the proliferation of nuclear weapons, given the possibility that its civil nuclear programme is feeding the search

for a secret military nuclear capability which will provoke counter-reactions in its Arab neighbours, not to mention in Israel. Moreover, today Iran has obtained blocking power on the three conflicts in the region which confront major Western interests: Iraq, Afghanistan and the Arab-Israeli conflict.

‘The EU needs to engage today, ahead of the inauguration of the new US president, in serious scenario planning on Iran’

The EU-3 dialogue with Iran may have helped to defuse the likelihood of an outbreak of military hostilities between Iran and the United States over the nuclear issue during the Bush administration. But tying relations with Iran exclusively to the nuclear question has not succeeded in halting Iran’s nuclear enrichment programme, despite three years of negotiation and now sanctions, and has only seen an expansion of Iran’s spoiling power in the region. New international efforts need to be undertaken to find a way both to bring Iran to an international approach towards the region’s problems and to reduce the likelihood of a nuclear-armed Iran.

This will require real political and economic incentives for regional cooperation combined with continued use of targeted sanctions on the nuclear issue. Whoever becomes president, the United States may find it difficult to enter into meaningful negotiations with Iran in the near term. There is deep mutual hostility between the two countries, exacerbated by the potential threat that Iran poses to Israel. Britain has so far managed to be both part of an EU diplomatic effort and a close friend of the United States in this matter. But it will not be enough to rely on the existing strategy, which demands that Iran first has to suspend its uranium enrichment, only for Britain to then risk finding itself confronted with an Iranian *fait accompli* and the imminent prospect of military action.

- The EU needs to engage today, ahead of the inauguration of the new US president, in serious scenario

planning. For example, where would the EU stand if the United States or Israel took unilateral action against Iran? Conversely, what should the EU response be in the event of a proven Iranian nuclear threat to other countries in the region, especially Israel? Does the EU regard Israel as having a right of pre-emptive self-defence under Article 51 of the UN Charter? If not, what steps would the EU take to attempt to assert the primacy of international law, and the authority of the Security Council, under the UN Charter – the very issue which split the EU at the time of the invasion of Iraq in 2003?

These are difficult issues, but waiting until the moment of crisis to try to sort out an EU view is a recipe for disunity and disarray. Britain is in too marginal a position to attempt to address these questions on its own. A joint EU and US–EU process offers the best prospect for progress, both *vis-à-vis* Iran and in the UN.

5. RESPONDING TO A MORE ASSERTIVE RUSSIA

Responding to Russia’s greater assertiveness is a further area where Britain’s interests will be well served by close coordination with its EU partners and by a common EU policy, which so far does not exist. Since Vladimir Putin came to power in 2000 and the quadrupling in the price of oil and tripling in the price of gas – Russia’s major exports during this period – outside countries have been able to do little to influence the centralization of political power in Russia or to establish a basis for enduring cooperation on certain key international challenges such as Iran. What is clear, however, is that Russia’s geographical proximity to the European Union and the growing penetration by its state-owned energy actors of EU economies present specific challenges to Britain and other EU countries that do not feature as large in US policy concerns.

The British government must make it a priority to build a more coherent EU approach towards Russia. Britain has a truly dual relationship with Russia. It exceeds Germany in terms of its high levels of foreign direct investment into Russia, but has experienced bilateral political tensions with

the Kremlin that make it more sympathetic than Germany to central European concerns about Russian policies.¹¹

Britain holds a position, therefore, that should enable it to help build a realistic EU strategy towards Russia. The EU approach should play up constructive areas of bilateral economic integration, but be explicit in its criticism of Russia's use of its economic and military muscle to interfere in the internal affairs of its sovereign neighbours, whether they are in the EU or outside. Russia's actions in Georgia in August 2008 were a serious wake-up call to EU countries in this respect. But previous efforts to extend Russian influence coercively into countries of the former Soviet Union were not heeded. These included direct action against an EU member state when Russia closed its pipeline supplying oil to Lithuania's major refinery after Gazprom was beaten by a Polish company in a bid to acquire it. It is now fair and proper that the EU use the pace and scope of the renegotiation of its new Partnership and Cooperation Agreement with Russia to signal its own displeasure at Russian actions in these and similar circumstances. And, should Russia persistently break the terms limiting the presence of Russian forces on Georgian territory, then the EU may need to take further political and economic measures. We touch on EU policy towards Russia in our discussion of EU enlargement and energy policy in later sections of this report.

The importance of a renewed transatlantic partnership

We have highlighted five areas where Britain can work with its EU partners to confront shared external challenges. They are not new and they loom large on the agenda of the British government and of the EU as a whole. Similarly, there are numerous other regional or transnational challenges where coordinated action within the EU will be an integral part of any credible solution that meets Britain's national interests. These stretch from fighting poverty, preventing conflict and improving economic prospects in sub-Saharan Africa, to coping with international crime or the proliferation of dangerous technologies across Europe. But shared concern on the part of

the EU member states does not necessarily translate into effective concerted action.

In this context, it is worth underscoring that, whatever the future divergences in transatlantic priorities and approaches in international affairs, US and European societies and governments will still share very similar concerns about threats to their interests, from being targets of terrorist attacks to the potential loss of economic primacy to Asia. And the rise on the international stage of new powers that do not always share their values could draw the US and EU closer together.

The United States and the EU acting together may no longer be sufficient to resolve most of the challenges described above, but a coordinated transatlantic approach is likely to be a necessary component of any effective response given their combined political and economic weight. However, the institutional framework in which the EU as a whole and the United States can enter into dialogue on these broad issues is inadequate. Yearly US–EU summits cover in their communiqués the full range of common transatlantic interests, but do not offer a serious venue where the diverse institutional influence of the EU, combining the resources of the European Commission, Council and Presidency, can share views and debate possible solutions with senior US leadership figures.

- It should be a British priority to find new structures for transatlantic debate, coordination and action. Options might involve expanding and deepening EU–US and EU–NATO structures or developing some form of new transatlantic EU–US forum, as has often been proposed in recent years, where the relevant officials could coordinate their approaches under the aegis of a ministerial council which would ideally meet up to four times a year.

NATO will remain the privileged forum for the strictly security and military dimensions of the transatlantic relationship. However, a new *bilateral* EU–US relationship should better reflect the growing international presence of the EU and the increasingly holistic nature of the areas of transatlantic coordination, which combine areas as diverse as trade, climate change, human rights, counter-terrorism and counter-proliferation, as well as security and defence.

3. Britain and EU enlargement

Promoting the enlargement of the EU since the 1990s has been one of the most important ways in which British governments have worked with other EU member states and the European Commission to improve the strategic security and economic prosperity of Britain and of the EU as a whole.

However, decisions about the further enlargement of the EU cut across at least two questions, each of which is critical to British interests. What sort of community of nations will the EU be in the future, in terms of its political philosophy, economic orientation and institutional organization? And how can the EU project stability and improve economic prosperity across its neighbourhood at a time when so many of its neighbouring countries are underdeveloped, while some are also unstable?

British interests in EU enlargement

Britain's support for EU enlargement reflects a number of national priorities which have also been widely shared in other EU capitals.

Overcoming the Cold War division of Europe: The expansion of the European Union to include 10 formerly communist countries over the last five years constitutes one of the EU's greatest success stories. The post-Cold War world offers no comparable example of so many countries establishing themselves so quickly as democracies with functioning, and, in many cases, rapidly growing market economies.

Extending regional stability and security: Membership of the

EU (and, for most of the new members, NATO) has brought historically unparalleled stability to a part of Europe which has traditionally been wracked by nationalist, territorial and other disputes that have spilled over to affect the rest of the continent, sometimes with dire consequences.

Expanding economic opportunity: EU enlargement has had, on balance, a strongly positive economic effect. Inclusion in the EU's Single Market has driven a significant increase in economic growth among all of the new EU members, thanks to a number of factors: their barrier-free access to a large and wealthy EU economy; the new competitive pressures within their domestic markets from other EU companies; the inflow of foreign direct investment from other EU and non-EU countries looking for new markets as well as lower-wage bases for manufacturing and export; and the willingness of the wealthier member states to transfer large amounts of money to the EU's poorer regions through the Structural and Cohesion Funds.

For their part, existing EU members, including Britain, have benefited from barrier-free access for their companies to a market that has grown by over 100 million people, as well as substantial demand for investment goods, cheaper EU locations for integrated business operations and – in the case of Britain and the growing number of other EU members that did not impose or have abandoned restrictions on the free movement of labour from the new entrants – a dramatic inflow of well-educated workers who have made up for labour shortages in both unskilled and skilled sectors of the economy.

Enlargement and the 'British view' of European integration

There has also been a more distinct dimension to Britain's attitude to EU enlargement, which reflects the sort of EU it is interested in building both internally and in terms of its openness to the outside world. Since joining the European Community in 1973, British governments have taken a different view from many in continental Europe for whom creating an ever-deeper political union trumped the pressures to widen the EU. There are two principal reasons.

First, Britain *has* broadly shared the concern of leaders from France, Germany and other founding members to

build through the Union the sort of political entity that would make future war between its members a practical impossibility. But Britain's vision was much less rooted than theirs in the perception that more powerful supranational EU institutions were as crucial to its success as cooperation between governments. In fact, an enlarged EU is seen as one in which a diversity of national priorities is likely to limit the sort of political integration and centralization of power in Brussels that many in Britain fear.

Second, Britain has not shared the notion of some on the continent of building up the European Union as an alternative to the power of the United States or as a pole of distinct values and interests. In both respects, majority British political thinking is more in tune with majority thinking in central and eastern Europe, where support for the United States remains high and where, in the wake of liberation from Soviet influence, there is no instinctive support for the further pooling of power.

Britain brings to the EU, therefore, an approach which puts great weight on the strategic and economic benefits of EU enlargement and very little weight on the negative possible effects of enlargement on internal EU cohesion and institutional construction.

Today's EU enlargement debate

Among the many factors that animated the opponents of the Constitutional Treaty in France and the Netherlands, in both cases EU enlargement was a contributory factor. The Treaty proposed nothing to make further EU enlargement easier in the future. However, polls have since confirmed voters' fears about the impact of immigration from the east and from Turkey on their society and culture and on job prospects, as well as their concern that west European companies would take jobs to the cheaper labour markets of the new entrants.

Hardening popular opposition

Political and popular opposition to further enlargement has continued to harden in the western half of Europe. Citizens in the west may appear to be resigned to the fact that further enlargement will take place, but there is little

active support for this happening. A Bertelsmann Foundation study in 2007 reported that as many as 72% of the Dutch, 70% of the French and 68% of the British respondents believed that the EU would continue to enlarge beyond 27 members; and 58% of the British and 53% of the Dutch respondents thought that Turkey would be in the EU by 2020.¹² On the other hand, the Eurobarometer poll for 2006 revealed equally strong opposition to this 'inevitable' enlargement among precisely the same countries.¹³

“The dire warnings about gridlock in the decision-making chambers of the EU have turned out to be unfounded so far”

If anything, popular concerns about the economic impact of enlargement are intensifying as migration takes place through the free movement of people and not only of labour. In Britain, the government dramatically underestimated the extent of migration from the new entrants into the UK – even if this was partly because it did not factor into its assessment the effect of other EU states' use of derogations to block the new entrants. These migrants are making a significant contribution to British tax and national insurance coffers. However, there has been increased pressure on welfare services, such as scarce low-cost housing and other public services in some parts of the UK, and media-led resistance to equal openness to immigration for the next round of entrants is growing.

Political concerns about enlargement

European political leaders have diverse concerns about enlargement. The dire warnings about gridlock in the decision-making chambers of the EU have turned out to be unfounded so far. A number of recent studies have shown that, across the EU institutions, levels of activity and output have remained similar to those preceding May

2004. After a dip in 2005, the aggregate amount of EU legislation passed in 2006 (setting aside the level of its political or economic impact) increased to almost the same level as it had reached prior to enlargement, and there have even been some gains in the speed of decisions.¹⁴

Yet there is no denying the fact that in western Europe there has been increasing political resistance to sustaining the pace of further EU enlargement, even to the countries of the western Balkans which enjoy Stabilization and Association Agreements that are early precursors to entry negotiations. This view has spread to mainstream groups such as the European Parliament's majority centre-right European People's Party. It found its voice in the French constitutional initiative proposed by President Chirac in 2005 to require a popular referendum on all future enlargements after Croatia – an initiative which was targeted especially at Turkey. Although President Sarkozy has led the Senate's decision to overturn this constitutional change, he has declared that no further enlargement of the EU will take place unless the Lisbon Treaty comes into force.¹⁵

There are many reasons for the growing opposition. The current global economic slow-down further raises political concerns about the impact of EU enlargement on jobs and investment inside the existing EU. Moreover, continuing high levels of corruption and a stalling of judicial reform in Bulgaria and Romania since their accession in 2007 serves as a signal that extending membership to other countries in the Balkans might be premature.

Further enlargement could also mean that developing EU external policies could become even more complex. In the most obvious case, there has been frequent disagreement over EU policies towards Russia between countries such as France and Germany, which have generally argued the case for closer EU–Russia relations, and some of the new entrants of central and eastern Europe, especially the Baltic states, which have more negative views based on their current and historical experience of Russia. This has spilled over into the debate over the stationing of US missile defence interceptors and radars in Poland and the Czech Republic respectively, and different approaches among EU member states towards the speed and extent of

further eastward enlargement of NATO and of the EU itself.

The case for a wider Europe

In this difficult context, the British government needs to be clear about its long-term goals as well as its tactics. We believe that Britain should be confident about, and communicate, the following points.

‘ We do not believe that it is necessary to define either an end-state for these new structures of governance, or, at this stage, the ultimate physical boundaries of the European Union ’

First, the European Union is more than a process of economic coordination and integration that is designed to improve the standard of living of its member states. It is a political project that aims to create new structures of governance, some supranational, some intergovernmental, among a group of European countries that share common internal and international challenges and that are committed to the values of democratic politics and open markets. Critically, we believe that, by spreading the EU's evolving system of governance to European countries currently outside the EU which share its values and aspirations and which are prepared to sign up to the binding rules that comprise EU law, Britain and all other EU members will enhance their future economic prosperity and security.

We do not believe, therefore, that notions of the ‘absorptive capacity’ of the EU should be used as a reason to oppose further EU enlargement, although it is reasonable to consider the speed at which further enlargement should proceed. The experience of the 2004 and 2007 enlargements, even without the Lisbon Treaty being in place, has

been that the EU can cope with quite radical enlargements, benefiting economically while not losing its decision-making coherence or diluting its shared values. With this experience in mind, an EU that is further enlarged from today's number could be able to deliver the benefits that its citizens expect.

Second, we do not believe that it is necessary to define either an end-state for these new structures of governance, or, at this stage, the ultimate physical boundaries of the European Union. It is possible, however, to be clear today about the mid- to long-term membership horizon that can be envisaged for the EU, based on the criteria mentioned above.

- Russia does not have an EU membership perspective in this time horizon. Despite being both a European and an Asian country in terms of history and geography, its geopolitical aspirations and actions as well as the domestic trajectory it is currently taking politically and economically mean that it is moving away from rather than towards such a perspective.
- The countries of North Africa and the eastern rim of the Mediterranean cannot be classified as European countries, despite their relative geographic proximity, and we do not foresee their becoming EU members in the future. Given the vital importance for the EU that these countries develop successfully over the coming years, however, the EU must devise interlinkages and forms of partnership with them that extend beyond the current Barcelona Process and even beyond the country-specific European Neighbourhood Policy (ENP) Action Plans. Although lacking the flexibility of its original design, the new Union for the Mediterranean, which President Nicolas Sarkozy has spearheaded on behalf of the EU in 2008, could help mobilize local resources and project proposals for the region to deal with its own development challenges.¹⁶
- The countries of the western Balkans already have a membership perspective. However, the pace of the pre-accession and accession negotiations is not only

being determined by their ability to consolidate their own transformation and state-building processes and to meet the EU *'acquis'* of existing laws and regulations. It is also being affected by calls within the EU for a pause after the accession of the 10 central and east European states, especially if the Lisbon Treaty is stalled for any length of time.

We believe that a region as scarred as the western Balkans, including not only Croatia (which is close to accession) but also Bosnia and Herzegovina, Serbia, Montenegro, Macedonia and Albania, as well as Kosovo, requires the full focus of the EU. It needs to be proactive in helping these states embark upon, and then complete, the accession process lest a sense of drift leave space for more radical or nationalist elements to offer alternative visions for their future. These visions could, in the short term, put at risk EU (including British) forces already in the region and could again entangle them there in further operations to make or protect the peace.

- The remaining countries of eastern Europe (Ukraine, Belarus and Moldova) should also have an eventual full membership perspective. The case for developing a formal pathway that could lead to enlargement negotiations with Ukraine is especially compelling. It is a large European country whose government and a majority of its people wish to join the EU. Ukrainian integration into the EU would further stabilize a country that has great economic significance for the EU in a number of areas, including food production and energy transportation. Its adoption of EU norms and regulations could have positive spill-over effects into Russia while providing a bulwark against the expansion of the current Russian blending of business and political interests. Following Russia's incursion into Georgia there is an urgent need to accelerate EU planning on Ukraine lest the Russian government seizes the initiative in order to build new roadblocks to Ukraine's ambition to join the EU.

Ukraine is still far from meeting the economic or regulatory criteria for membership, but it has a vibrant

if chaotic democracy which would benefit greatly from the discipline of a reform agenda that is linked to EU membership expectations and negotiations. The ENP Action Plan for Ukraine tackles many of the key policy issues, but it lacks the leverage which the EU brings through its membership negotiations and does not provide the same level of internal discipline inside Ukrainian decision-making circles.

President Sarkozy has already suggested the signing of an Association Agreement with Ukraine,¹⁷ while the Swedish and Czech governments have also been developing new ideas for building closer EU–Ukraine relations. Britain should now work with these governments and with interested EU neighbouring states such as Poland and the Baltic states to seek rapid recognition of Ukraine’s membership perspective in the EU, even if the timescale for achieving actual membership may inevitably be protracted.

- Russia appears to be intent on reasserting its influence over countries in the Caucasus like Georgia that are pursuing a path of democracy and market openness and that offer the means to lessen European dependence on Russian energy supplies. Given the Caucasus’ European linkages, the EU should consider developing a membership perspective with Georgia and other countries of the Caucasus, provided, of course, that they demonstrate a full commitment to democratic norms, an open economy and the ability to take on the EU’s legal structure.
- Finally, the EU should continue to negotiate with Turkey with the objective, should Turkey accept and meet the necessary entry criteria, of its achieving full EU membership. There will be enormous resistance within the EU to this objective and Britain must prepare for a protracted struggle.

Thinking about Turkey

Britain has long been a supporter of Turkish membership of the EU, ever since Turkey was recognized as a European

country in its Treaty of Association in 1964. Turkey signed a Customs Union with the EU in 1995 and over 50% of its exports now go to the EU. Given the pledges made by the democratically elected AK Party to meet the necessary political, legal and economic criteria for membership, EU leaders agreed at their summit in 2005 to open negotiations on Turkey’s full accession to the EU.

Since then, however, opposition to Turkish membership has intensified greatly for a host of reasons. Some are long-standing: the Turkish population is primarily Muslim, even though the state is secular; the country’s large and growing population would change the political balance within EU institutions; and the lack of economic development in parts of the country could put real – if often exaggerated – strain on EU budgets. Some concerns are more recent: fears of migration from Turkey and of the impact of a more active Islamic bent to its domestic politics within the EU. Since the actual membership negotiations began, both President Sarkozy and Chancellor Merkel have joined others in expressing their opposition to full membership and their preference that the EU should offer Turkey an arrangement short of this – a ‘privileged partnership’.¹⁸

- We believe that going back on the pledge made in 2005 and predetermining the outcome of the accession negotiations would have very negative consequences for the EU as well as for Turkey.

Countering calls for ‘privileged partnership’ as the ultimate objective of the negotiations will require a careful campaign by British politicians and diplomats and others in the EU committed to Turkey’s EU membership. This campaign will need to take into account the visceral concerns over Turkish membership in many continental EU countries. The campaign will need to focus, therefore, on Ankara as much as on European capitals, given the continuing political and constitutional tensions within Turkey and also the critical need to resolve the Cyprus question if the accession talks are eventually to succeed.

The campaign also has to focus on what the EU would gain from Turkish membership, especially at a strategic level, including its roles in helping strengthen the Black

Sea region and as an alternative transit country for oil and gas into the EU. Britain should also continue to highlight the positive effects of fully integrating a secular democratic state with a majority Muslim population into the EU. What sort of message the eventual inclusion of a Muslim-majority state into the EU would give to other parts of the Muslim world is hard to tell. What is clearly important is that, for those many EU member states that have sizeable domestic Muslim populations, the eventual accession of Turkey could help to signal the ecumenical and inclusive character of the EU and assist the process of better integrating Europe's large and growing Muslim minorities.

‘Turkey's accession could help to signal the ecumenical and inclusive character of the EU’

The time horizon for Turkish membership of the EU is not short, and Turkey has many steps to take. But Britain should move forward in good faith to seize the positive dimensions of the EU's decision to open negotiations and use the intervening time period to address popular concerns.

Helping to put the strategy into practice

If Britain is to continue as a successful advocate of the EU's further enlargement, then it must help the EU be better prepared for the realities of EU enlargement rather than simply be a champion of the strategy.

Supporting EU adjustment: The net positive economic effects of enlargement and the free movement of labour are clear. So, however, are the political pressures this process engenders. The lesson on labour migration, for example, is not to withhold free movement of persons but to prepare for it by

anticipating demand patterns and better assessing the readiness of economies to cope. At a minimum Britain could share with other EU countries its experiences of absorbing central European workers. A number of studies by academic researchers and the Department for Work and Pensions have found that migrant workers have not contributed to a rise in unemployment.¹⁹ Rather, they have alleviated shortages in segments of the labour market that Britons have shunned.

Ensuring new entrants abide by their commitments: Britain should support the European Commission in thinking through new ways of ensuring that membership negotiations really do lead to the embedding of robust democratic institutions and the implementation of new EU-compliant laws within applicant countries. The decision to enter into membership negotiations must mean that these are genuinely intended to lead to enlargement, subject to the relevant conditions being met. The timing, however, should depend more explicitly on the ability of the applicant country to demonstrate not only that it has put EU regulations on its books, but that it can point to a successful track record of implementation before accession is formally ratified.

In addition, as the cases of Bulgaria and Romania show, post-accession support and surveillance will be equally important. Penalty clauses for non-implementation after accession, such as budget disallowance, need to be meaningful and enforceable for longer than is currently the case. In the Structural Funds, which amount to sizeable inflows for some of the lowest-income countries and could be withheld, the EU has a lever with genuine clout.

Avoiding a category of second-class membership: The EU should avoid developing an ‘enlargement minus’ or ‘privileged partnership’ model in which parts of the *acquis* would be taken out of the scope of the membership package or which would accept the idea of permanent derogations. These ideas could lead to a two-tier approach to further enlargement that would undercut the strategic benefits of enlargement both for the EU itself and for the new applicants.

4. Enhancing Britain's domestic security

An island nation

Britain has long been ambivalent about cooperating with other EU member states to enhance its domestic security. As an island nation with a long history of believing itself able to protect its physical borders, it has been reluctant to enter into agreements with other EU member states that involve reliance on the effectiveness of their controls to ensure its domestic security. The most explicit example of this ambivalence is Britain's refusal to lift the physical controls it imposes at its borders on the entry of citizens from both EU and non-EU member states (including its own citizens, who regularly face lengthy queues at airports) in order to be part of a Europe-wide zone of security.

‘There are significant ways in which Britain can enhance its domestic security by working more closely with EU member states and institutions’

More recently, the British government insisted on having opt-outs from the new legal framework for provisions on Freedom, Justice and Security (FJS) affairs

contained in the Lisbon Treaty. The idea of pooling sovereignty in this area has also been controversial in Britain for political, and not just practical, reasons.

However, in a fast-changing world where intelligence and other cooperation with partner countries is ever more important, we believe that there are significant ways in which Britain can enhance its domestic security by working more closely with EU member states and institutions in this area. If this is properly and openly explained it is reasonable to expect that a majority of the British public would support such an approach.

New threats to Britain's domestic security

That Britain is as vulnerable as any other European state to the risks of international terrorism is in no doubt. The terrorist attacks of 7 July 2005, the failed attacks of 21 July, just two weeks later, the alleged plots against transatlantic flights uncovered in August 2006 and the attempted attacks in London and Glasgow in 2007 all served as jarring examples of how long-resident British citizens and more recent immigrants can be motivated to carry out horrific acts of violence within the country. The former head of MI5 indicated in late 2006 that British intelligence services were tracking 1,600 potential suspects and knew of 30 potential plots of a terrorist nature.²⁰

There are many reasons why Britain risks remaining a principal target for international terrorist groups and for a radicalized minority within the country. These include its support of military action in Afghanistan and Iraq; its alliance with the United States; and its position as a world financial centre. Future plots, like the most recent ones, might count upon logistical as well as motivational support from extremist groups in Pakistan or the Middle East. However, international terrorist groups such as Al-Qaeda have deliberately spread their operations across Europe since the late 1990s, using different countries for different aspects of their terrorist planning and operations.

It is also the case that an expanded EU will ease the movement of people between and into its member states, including from those whose borders touch on parts of eastern and southeastern Europe, such as Ukraine, Moldova

and Albania, where firm authoritarian control has given way to a more anarchic environment. This could further hamper the ability of Britain and other EU members to deal with the spread of new risks to their domestic security, such as organized crime, illegal migration and the trafficking of people, drugs and other illicit goods. Britain already suffers as much as any other European state from the effects of international organized crime.²¹

Recent British adaptation

Under the government of Tony Blair, Britain took a number of steps to adapt national laws and practices as well as to develop new organizational options to deal with these growing threats, from the creation of the Serious Organised Crime Agency (SOCA) to the tightening of anti-terrorism legislation. It is clear, however, that there is a limit to what can be achieved within Britain's borders alone or even with key allies outside Europe such as the United States. Confronting a terror plot aimed at London but planned and coordinated by militant cells in Stockholm, Frankfurt and Calais requires Europe-wide structures so that Britain can better coordinate judicial, police and counter-terrorism operations with security services in the countries where the terrorist activity is being plotted.

The terrorist attacks of March 2004 in Madrid and July 2005 in London led to a wave of new initiatives to enhance law enforcement and judicial cooperation among EU member states. SOCA units now operate in many British embassies across Europe to strengthen coordination with their European counterparts. And, at the EU level, Britain was able to use the provisions of the European Arrest Warrant, which came into force in January 2004, in order to extradite one of the suspects in the attempted bombing attacks of 21 July 2005.²²

British officials have played a leading role in devising other new forms of cooperation. However, the government has decided that it wishes to preserve the flexibility of the intergovernmental approach to such cooperation. Specifically, it does not want to subject itself or its successors without qualification to the requirement in the Lisbon Treaty that aspects of law enforcement and judicial

practices might have to be adapted to, integrated into and governed by the 'Community method'.²³

A steady process of EU integration

Establishing the Schengen Area

The British approach stands in contrast to the steady deepening of integration in continental Europe on matters of domestic security. Even before the adoption of the 1985 Single European Act which defined the European Community's internal market as 'an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured', five EC members (France, Germany and the Benelux countries) decided to advance EC-level legislative action which would be needed to make a true frontier-free Europe. Though it was not implemented until a further agreement signed in 1991, they created the so-called Schengen Area within which the participating countries agreed to abolish frontier controls on people as well as on goods, capital and services.

The establishment of the Schengen Area created the need for more intensive cross-border cooperation to ensure the security that had hitherto been provided by national border controls continued under a more informal system of checks. Reflecting the experience gained through this initiative, the Maastricht Treaty of 1992 contained the first legal provisions for cooperation between EU member states in the area of Justice and Home Affairs (JHA). What became known as the 'Third Pillar' of EU cooperation operated, largely at British insistence, on an intergovernmental basis (as does the Second Pillar of cooperation in foreign and security policy).

The Amsterdam Treaty of 1997 contained some radical changes. Significantly, from a British perspective, the terms and (confused) *acquis* of the Schengen agreement were incorporated into the EU treaties. In exchange, Britain (plus Ireland and Denmark) were given the right to maintain their own border controls and to apply to opt into individual measures taken at the EU level if, but only if they wished to do so. These measures focused on cross-border security issues, including judicial cooperation in civil matters, migration, asylum and visa questions.

The Lisbon Treaty and implications for Britain

Reflecting the intention laid down in the Amsterdam Treaty to move decision-making in most JHA-related issues to the EU's First Pillar system, the Lisbon Treaty agreed to make decisions by qualified majority vote the norm in the area of justice, freedom and security. The Lisbon Treaty would give the European Parliament extensive rights of co-decision. The role of the European Court of Justice would be similarly extended. These changes would effectively abolish the so-called Third Pillar of intergovernmental cooperation established by the Maastricht Treaty and, for most purposes, bring JHA issues within the scope of Community competence.

At the same time, under the treaty, Britain's right (not obligation) to opt in would be extended to police and judicial cooperation. Its ability to decide independently whether it wished to participate would be maintained by a series of complex procedures. These include a five-year transitional period before existing measures currently taken at the intergovernmental level (such as the European Arrest Warrant) would become subject to First Pillar rules. Britain would have the right to opt out of these existing measures during this period if it wished to avoid allowing majority voting and European institutions to have a say over British practices and laws in the specific area concerned.

Just as importantly, however, wherever the British government decided in the future not to opt into a JHA measure, its EU partners would also have the right, under the treaty, to oblige Britain to opt out of any existing related measures if they judged that Britain's opt-out of the specific measure undermined the effectiveness of the broader related measures.

In addition, Britain's right under the Lisbon Treaty to opt into measures that might suit its national interest and security would not automatically give it unfettered access to EU arrangements. For example, the UK's planned participation in the Schengen Information System II (currently under development), an important vehicle for sharing intelligence among EU member states about criminal or terrorist targets, is limited because full access to the immigration data is open only to those countries which have agreed to abolish their frontier controls under the Schengen Agreement and have instituted the necessary national procedures for verifying the identity of their citizens.

EU initiatives outside the Lisbon Treaty

Irrespective of the fate of the Lisbon Treaty, it is more than likely that most of Britain's EU partners will move towards a greater approximation of their laws and practices in the areas of domestic security and judicial practice over the coming decade, even if this will be a slow and laborious process given the sensitivity of these areas of national policy-making. EU member states are waking up to the fact that they are all now targets not only of new influxes of illegal migration, but also of terrorist groups which choose not to distinguish between the nuances and differences in their foreign policy.

Coordination will be needed not only at the levels of border management, law enforcement and judicial cooperation, but also, given the terrorist threat, in risk mitigation and disaster recovery. This could involve new forms of civil-military cooperation across borders, management of transportation linkages and common critical infrastructure, and even coordination in the delivery of medical supplies. The decision in recent years to establish three new agencies in the field of justice and home affairs – Europol, Eurojust and Frontex – reflects the need and determination of EU members to work together more closely to help address particular pan-European law enforcement challenges (see box). Each of these three areas of EU coordination offers opportunities for Britain to increase its domestic security. However, the process of further integration among continental European states will be facilitated by the fact that they share broadly similar legal systems, unlike England, Ireland, Cyprus and Malta whose legal systems are based on Common Law.

The British dilemma

In the absence of the Lisbon Treaty, Britain would escape the dilemma of how to use the five-year transition period before having to decide in which aspects of EU JHA policy it wanted to participate (accepting that, under the treaty, these would move from an intergovernmental system to become subject to full EU legislative and judicial procedures). But the more fundamental dilemma of whether or

European agencies working on Justice and Home Affairs

- *Europol's* primary task is to facilitate the exchange and subsequent analysis of operational information and the coordination of police activities between member states in the areas of terrorism, unlawful drug-trafficking and other forms of serious international organized crime. Most recently, it helped break up a world-wide drug-trafficking ring which had its operational base in eastern Germany.
- *Europol* cooperates closely with *Eurojust*, which is led by a college made up of 27 judges or prosecutors (one from each member state). With direct expertise of all member states' legal systems comprised within a single body, it is making cross-border investigations and prosecutions much easier. Established in 2002, *Eurojust* has already had a number of successes, such as the prosecution and conviction in autumn 2006 of a multinational people-smuggling ring operating in, among others, the United Kingdom, France, Italy and Turkey. *Eurojust* facilitated the coordination between the judicial authorities of the relevant member states.
- Recognizing the increased pressure of illegal immigration into the EU, the Union also set up a joint border agency, called *Frontex*, in 2005. The agency's mission is to pool member states' resources in order to address specific regional pressures on individual, or groups of, member states. To date, *Frontex* has deployed operations to tackle the flow of illegal migration to the Canary Islands, the Baltic Sea region and the central Mediterranean area, for example. It is also helping member states deal with the arrival of illegal migrants at airports, and alleviating the pressure on states hosting major sporting events such as the Football World Cup in Germany and the Torino Winter Olympics in 2006. Because Britain remains outside the Schengen Area, it is not a full member of *Frontex*, but it has been participating in some of its operations.

not to opt into particular EU measures that use the Community method of decision-making in the JHA area – for example, of whether to join the full Schengen system – will remain whatever happens to the treaty.

British decisions must be a mixture of the political and the practical. Politically, control of national frontiers, decisions on migration policy and judicial rules are matters which help define Britain as a sovereign nation-state. They reach beyond the material impacts of European economic integration and can directly affect the security of citizens, their social interaction and, through the judicial process, their relationship with the state, including issues of civil liberties.

Thinking practically, there will be cases where the British government may simply not have confidence in the ability of certain EU partners to enforce the judicial, policing, border control or visa measures on their books, especially as the EU (and therefore, ultimately, the Schengen Area) continues to enlarge. Integrating fully into an EU-wide area of 'justice, freedom and security' under

these circumstances may not be in Britain's interests. As an island it has advantages over its continental counterparts in terms of border monitoring. There is also the practical as well as political question of the need for Britain to introduce a system of identity cards if it is to be able to integrate into the Schengen system. Currently, this raises widespread domestic concerns over civil liberties, setting aside the questions of cost and effectiveness.

On the other hand, a British debate that defines domestic security from an island perspective disregards the increasingly mobile nature of twenty-first-century threats. Britain would have much to gain from exploring how it might deepen its integration in specific, targeted EU initiatives on JHA matters.

In the area of criminal law, it would greatly assist British as well as other countries' police operations to have a definition of a particular crime that is common to all EU member states. Otherwise, if the British police are involved in an operation involving criminals active in Britain and

Austria and based in Slovenia, the police forces of the three countries concerned have to identify the common crime between all three jurisdictions before action can be taken against the criminals.

As the new EU entrants incorporate their intelligence about criminals and other suspects into the Schengen Information System (SIS), Britain will increasingly wish to have full access to the system. This may call into question the benefits of preserving physical border controls on travellers from the Schengen Area.

Moreover, the more fragmented European approaches are to enhancing their domestic security, the more difficult it will be for Britain and its partners to negotiate improvements with third countries such as the United States or with key neighbours, whether Ukraine, Russia or the Maghreb states. In the case of the United States in particular, EU member states, including Britain, have been forced to react to stringent US homeland security measures with extra-territorial implications (releasing detailed passenger name records, for example), rather than being in a position to negotiate measures that are mutually acceptable across the EU from the outset.

There will, of course, be cases where British and other EU governments may have a special national interest in not allowing a majority vote to change national law in the sensitive domain of criminal law. For example, British ministers would be unlikely to follow the continental model whereby DNA evidence cannot be adduced as grounds for a new trial for an offence of which someone has previously been acquitted. However, even if Britain were a full participant in the Schengen system, current treaty arrangements (and even the Lisbon Treaty) would offer Britain protection, since they provide for unanimity in this area of integration.

Defining the British interest in EU cooperation on domestic security

The key question, therefore, is whether the continuing political and practical concerns mentioned above are reasons enough for the British government to operate as a less than full participant in the EU's JHA process and Schengen system.

If the Lisbon Treaty comes into force, the right to opt into specific EU measures governing migration, visas, and police and judicial cooperation on an 'ad hoc' basis may be the right approach to safeguard Britain's security. Preserving the right to opt out of other measures would fully protect Britain from EU policies which evolve in ways that are bureaucratic and insufficiently flexible to deal with today's mutating challenges to its domestic security. It may also be the case that, thanks to initiatives such as the regular meetings between the six largest EU member states on matters of domestic security, Britain can help design new European initiatives without having to commit to pooling its sovereignty fully in this dimension of EU integration. Only experience will tell. But meanwhile the issues at stake are of huge and immediate importance to the security and well-being of British citizens.

The British government will need to be hard-headed and rigorous in assessing the national interest in this area of policy.

- We recommend, therefore, that the British government should commission annual, independent audits of the performance of EU measures in the JHA area and of the gains and costs to national security of the British engagement or lack of engagement with these measures. The findings of these audits should be reported to parliament and debated.
- It may transpire that Britain is unable to participate in significant areas of EU action against international crime and terrorism which depend on deeper integration with its EU partners, including within the Schengen system. In that case the government should present the issues in a straightforward way so that parliament – or the British people directly – can weigh their concerns about sovereignty and civil liberties, on the one hand, against the effectiveness of full participation in the EU-wide measures, on the other. What Britain cannot afford to do is to pretend that the opt-in system fully protects its security if, with experience, it find that this is not the case.

5. The economy

As Britain looks to the future, a central priority for its government will be to improve the economic competitiveness of the country so as to ensure the existence of high-quality jobs, steady economic growth and improvements in social welfare. Achieving this goal will be a difficult task given the growing economic pressures emanating from beyond Britain's shores. And, just as with domestic security, finding new ways to cooperate with its EU partners will be an important

component in helping to drive British economic growth in the future.

The economy is one area where Britain has already gained much from its membership of the European Union. Operating within a largely barrier-free and wealthy single market of some 495 million people, British companies now send 60% of their exports to other EU countries and draw 46% of their foreign direct investment earnings from Europe, compared with 21% from the United States.²⁴ Over 3.5 million British workers are employed by companies from mainland Europe that have invested in Britain and it has been estimated that well over three million jobs in Britain depend on demand from other EU countries. And one of its most substantial economic assets, the City, has benefited from a deregulation of financial services across the EU that Britain has played a leading part in effecting. Overall, Britain's flexible labour markets with their low social costs have

Figure 1: UK exports, 2007

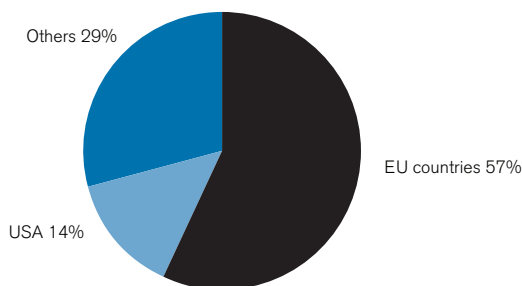


Table 1: Top 12 trading partners – exports, 2007

	£ million
USA	32,032
Germany	24,278
France	17,800
Irish Republic	17,477
Netherlands	14,879
Belgium	11,682
Spain	9,831
Italy	9,013
Sweden	4,805
Switzerland	3,850
China	3,781
Japan	3,762

Note: Provisional data.

Source: UKTradeInfo, HMRC, Overseas Trade Statistics. © Crown copyright

Figure 2: UK imports, 2007



Table 2: Top 12 trading partners – imports, 2007

	£ million
Germany	43,444
USA	26,072
Netherlands	22,659
France	21,493
China	18,795
Belgium	14,679
Norway	14,595
Italy	12,861
Irish Republic	11,215
Spain	10,088
Japan	7,982
Hong Kong	6,988

Note: Provisional data.

Source: UKTradeInfo, HMRC, Overseas Trade Statistics. © Crown copyright

Figure 3: Net international investment positions abroad by region, end 2006

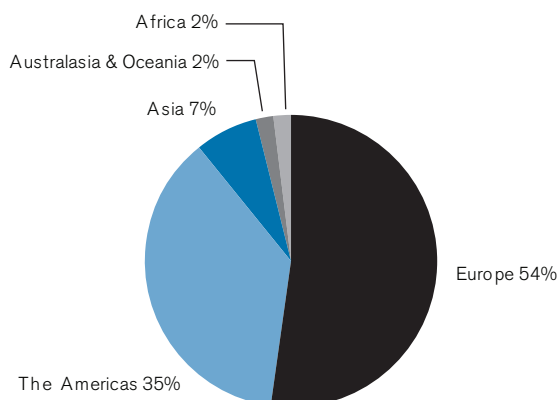


Table 3: Top ten target locations by UK FDI international investment positions abroad, end 2006

Country	% of total
USA	25
The Netherlands	12
Luxembourg	8
France	5
Jersey (UK Offshore Islands)	4
Guernsey (UK Offshore Islands)	4
Spain	4
Irish Republic	3
Hong Kong	3
Canada	3
Top ten countries	71

Source: *Business Monitor MA4: Foreign Direct Investment 2006* (Newport: National Statistics, February 2008). © Crown copyright 2008, p. 32.

Figure 4: Net FDI International positions in the UK 2006

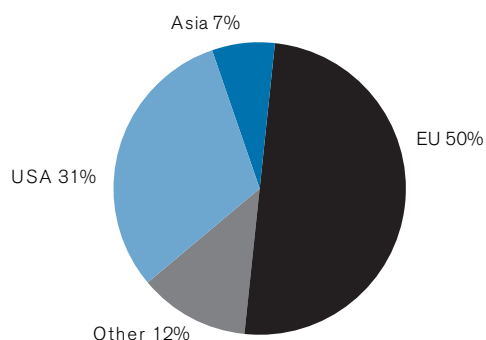


Table 4: Top ten investor countries by FDI international investment position in the UK, end 2006

Country	% of total
USA	31
The Netherlands	21
France	9
Germany	9
Spain	5
Canada	3
Switzerland	3
Japan	3
Luxembourg	2
Irish Republic	1
Top ten countries	87

Source: *Business Monitor MA4: Foreign Direct Investment 2006* (Newport: National Statistics, February 2008). © Crown copyright 2008, p. 94.

helped it account for almost 30% of all foreign direct investment into the EU in 2006/07, making it an important base for the operations of EU and non-EU investors alike.²⁵

Dynamic Britain versus sclerotic Europe: the end of the story?

According to one reading of recent statistics, the UK has been one of the best economic performers in the EU in

recent years. For many Britons, a low-unemployment, fast-growing, dynamic Britain has stood in contrast to a sclerotic, stagnant Europe beset by high unemployment and low growth. In fact, Britain's recent economic performance reveals a far more mixed picture and there are serious concerns for the future.

The good ...

As can be seen from Table 5, the UK did indeed outperform its main large EU counterparts, France, Germany and Italy, during the early early years of this decade in the crude

aggregate of GDP growth. There were a number of explanations for this relative British success. Some cite the results and repercussions of the Thatcher revolution in the 1980s, the follow-through by John Major in the 1990s, including the privatization of nationalized industries and breaking of union power, and the Blairite/Brownite consolidation which followed – deepening and widening national markets and enhancing labour flexibility. This gave Britain an advantage over its more rigid and interventionist large European counterparts. In addition, British governments followed disciplined macroeconomic policies from the early 1990s, targeting inflation above all and providing a more predictable monetary environment for business planning and investment as a result. Giving the Bank of England its independence contributed to this sea change from Britain's economic gyrations of the 1970s and 1980s. There were, of course, some exogenous factors at work. For example, Germany continued to bear the costs of reunification during this period, and British government finances benefited enormously from the rise in production of North Sea oil and gas. But it should also be noted that, under the Chancellorships of Kenneth Clarke (1993–97) and Gordon Brown (1997–2007), Britain conducted significantly more expansionary economic policies than the Eurozone.

As a result of these factors, Britain's decision not to give up the pound and enter the EU's Economic and

Monetary Union (EMU) in 1999 did not lead to an outflow of foreign direct investment or harm Britain's competitive position. Nor did it bring about the loss of the City of London's position as Europe's leading international financial centre.

The bad ...

However, the notion that Britain has been a metaphorical, as well as literal, island of uniquely strong growth and robust labour markets in the European Union ignores important weaknesses in its economy. Setting aside the current turmoil in financial markets and the bursting of the property bubble, a number of more structural factors mean Britain should prepare for difficult economic times ahead.

First, a more detailed look at the continental European economy shows that Britain's performance is less impressive. Compared to just the 14 richest and oldest pre-2004 EU members, Britain has more often than not been outperformed since 1999 by Ireland, Finland, Greece, Luxembourg, Austria, Sweden and Spain, the last fuelled by its own housing and construction boom and by rapid immigration (see Table 5). Ireland and some of the new member states from central and eastern Europe such as Latvia and Slovakia have, until recently, posted growth rates treble the UK rate. And, while it is reasonable that

Table 5: Real GDP growth in sample countries (1997–2007)

	1999	2000	2001	2002	2003	2004	2005	2006	2007
UK	3.0	3.8	2.4	2.1	2.8	3.3	1.8	2.9	3.1
EU15	3.0	3.9	1.9	1.2	1.2	2.4	1.8	2.9	2.7
EU27	3.0	3.9	2.0	1.2	1.3	2.5	1.9	3.1	2.9
Eurozone	2.9	3.9	1.9	0.9	0.8	2.1	1.7	2.8	2.6
Denmark	2.6	3.5	0.7	0.5	0.4	2.3	2.5	3.9	1.8
France	3.3	3.9	1.9	1.0	1.1	2.5	1.9	2.2	2.2
Germany	2.0	3.2	1.2	0.0	-0.2	1.2	0.8	3.0	2.5
Italy	1.5	3.7	1.8	0.5	0.0	1.5	0.6	1.8	1.5
Latvia	3.3	6.9	8.0	6.5	7.2	8.7	10.6	12.2	10.3
Netherlands	4.7	3.9	1.9	0.1	0.3	2.2	2.0	3.4	3.5
Poland	4.5	4.3	1.2	1.4	3.9	5.3	3.6	6.2	6.6
Slovakia	0.0	1.4	3.4	4.8	4.8	5.2	6.6	8.5	10.4
Spain	4.7	5.0	3.6	2.7	3.1	3.3	3.6	3.9	3.8
Sweden	4.6	4.4	1.1	2.4	1.9	4.1	3.3	4.1	2.7
US	4.4	3.7	0.8	1.6	2.5	3.6	2.9	2.8	2.0

Source: Compiled from Eurostat data.

Table 6: Employment data in sample countries (second quarter 2007)

	Overall employment rate	Youth unemployment rate	Overall unemployment rate
UK	71.1	14.7	5.3
EU27	65.3	15.6	7.2
Denmark	77.3	7.1	3.7
France	63.9	22.1	8.8
Germany	69.1	11.0	8.5
Italy	58.9	18.6	5.9
Latvia	67.6	9.3	5.8
Netherlands	76.0	6.1	3.3
Poland	56.8	22.3	9.9
Slovakia	60.4	20.5	11.3
Spain	65.8	18.2	8.1
Sweden	74.3	18.8	6.1

Source: Compiled from Eurostat data.

Britain should want to compare itself with the EU's biggest economies, the difference is not especially dramatic.

A closer look at employment patterns across the EU is also revealing. As Table 6 indicates, the UK's unemployment rate is indeed noticeably lower than in France and Germany. It is also lower than the average for the 27-member EU taken as a whole. However, eight EU countries – including Denmark and the Netherlands – have lower unemployment rates. Britain's youth unemployment rate is slightly lower than for the EU27 as a whole and much better than the terrible figures for France and Poland. However, it is well above Germany's and more than double the rate in Denmark and the Netherlands.

To add to this more mixed record of past performance, the 2008 economic indicators reflect a more structural set of weaknesses in the British economy. These include a worrying dependence on consumption-led and debt-fuelled growth, low productivity growth, poor economic infrastructure and weak educational standards. Some worry too about the rise in public expenditure as a proportion of GDP, although this has been low by EU standards, and it was an aim of recent government policy to 'catch up'. However, there are now growing concerns about budgetary constraints and, for example, levels of business taxation.

A more competitive European context

Most EU member states now understand the need to undertake fundamental economic reforms if they are to meet the competitive challenges of the next decade. It would appear that they are starting to adopt the best aspects of each other's models in the quest for improved economic competitiveness. As the economist André Sapir has pointed out, different governments are using different models to try to deal with the perennial problems of job-creation, social welfare provision and economic growth in ways that suit the political and cultural diversity of the states that make up the Union.²⁶

Over the next few years, Britain is likely to find that other EU member states start to adopt some of the competitive measures that it and the new entrants to the EU adopted in the last decade to spur their own economic growth. A combination of labour market reform begun by the Schröder government and corporate-led restructuring in Germany, for example, has led to a significant decline in unemployment, from a peak of just over 5 million in early 2005 to around 3.6 million by the end of 2007. Germany, once again the world's leading exporter, is running a current account surplus of some 6% of GDP, compared to a 3% deficit in the UK. In France, Nicolas Sarkozy has identified as key aims of his presidency reforming the labour markets and the pension system as well as fighting

his country's traditional hostility to globalization. However difficult implementing these reform measures might be in practice, the need to take them now appears to have majority support.

When combined with continuing strong growth in many of the central and eastern European economies, this ongoing series of national reforms might start to cut into Britain's ranking in the EU's economic league tables. These reforms ought to be welcome, not least because prosperous neighbours mean opportunities for British exporters. The key question for Britain as well as for the rest of the EU, however, is whether the EU and its individual member states are adapting sufficiently in order to prosper in a world economy that can only become increasingly competitive in the next decade.

The potential and limits of European economic adaptation

There are two main broad dimensions in which EU member states are cooperating to maintain their economic competitiveness: first, through the management of the single currency; and, secondly, through the Lisbon Strategy (in which the member states and the Community have comprehensive programmes for economic reform) and the further deepening of the Single Market – initiatives Britain has championed in the EU.

The effects of monetary union

The single most significant innovation in the European economy in the last decade has been the introduction of the euro. Since 1 January 2008, the Eurozone has comprised 15 of the 27 EU members, with a 16th (Slovakia) due to join in January 2009.²⁷ This number is likely to increase significantly over the next decade. The remaining nine former communist countries which joined the European Union in 2004 and 2007 are legally obliged to adopt the single currency when they meet the entry conditions. Only three of the 'old' EU member states have chosen not to adopt the euro so far – Sweden, Denmark and, of course, Britain.

The euro has been a success in a number of senses. It has helped usher in a period of historically low inflation and

low interest rates across the European continent. It has been adopted smoothly by all of its member states, and further rounds of enlargement have not destabilized it. After an initial period of decline, the euro has strengthened dramatically against the dollar and other currencies. Euro-denominated corporate bonds now exceed the amount of dollar bonds and are traded in financial markets across the world, demonstrating that financial markets regard the euro as a stable and desirable currency in which to invest. And the deepening of financial markets that this has instigated across continental Europe has been to the advantage of business. Finally, the euro's role as a reserve currency is increasing steadily, accounting now for over 30% of official central bank reserves worldwide.²⁸ The question of whether the euro is here to stay or not is no longer an issue.

‘Euro-denominated corporate bonds now exceed the amount of dollar bonds and are traded in financial markets across the world’

On the other hand, there have been some important disappointments which signal concerns for the future. The Eurozone is some way from being an optimal currency area. There are strong divergences between the growth patterns and inflationary pressures in different Eurozone members, and national governments can no longer set interest rates or vary exchange rates to help their economies adjust. Also, faced with economic stagnation in the early years of this decade, France and Germany, in particular, chose to flout the rules of EMU's Stability and Growth Pact. They persisted with budget deficits in excess of 3% and were slow to undertake full-scale economic reforms. While the German and French governments are now being forced to adjust, the bad feeling among the smaller members of the Eurozone at this high-handed behaviour may have inhibited the Eurogroup, comprising the finance ministers of all euro members, from achieving effective macroeconomic coordination. Since 2005 there

have been reforms, not just of the Stability and Growth Pact, but also of the way in which the Eurogroup functions. Although there are features of the governance of the euro area that remain unsatisfactory, it now looks much more promising.

Nor has the creation of the Eurozone served as a major boost for the European economy. As the Centre for Economic Policy Research pointed out in a report in June 2006, reduced transaction costs owing to the absence of different currencies across the Eurozone appear to have had some positive impact on intra-EU trade. Exports between countries using the euro increased by 9% while exports to the Eurozone from the three EU countries that do not use the euro increased by 7%. On the other hand, EU economic growth figures show no correlation with the use or non-use of the euro. It is, of course, all but impossible to separate out the influence of the euro from other factors. However, it is clear that the adoption of the euro has not coincided with a dramatic improvement in either absolute or relative growth figures.²⁹

‘The creation of the euro may force those countries that have not yet done so to tackle their structural problems’

By removing the soft options of devaluation, artificially low interest rates and unfettered fiscal expansion, the creation of the euro may force those countries that have not yet done so to tackle their structural problems. That remains a slow process, as can be seen in the resistance of EU members to addressing the two central dimensions of their economic interaction – the creation of a truly Single Market and the need for far-reaching national economic reform. Both of these dimensions were to be addressed in the EU’s Lisbon Strategy.

The Lisbon Strategy

Launched in 2000, and re-launched in March 2005, the Lisbon Strategy originally aimed to build in the

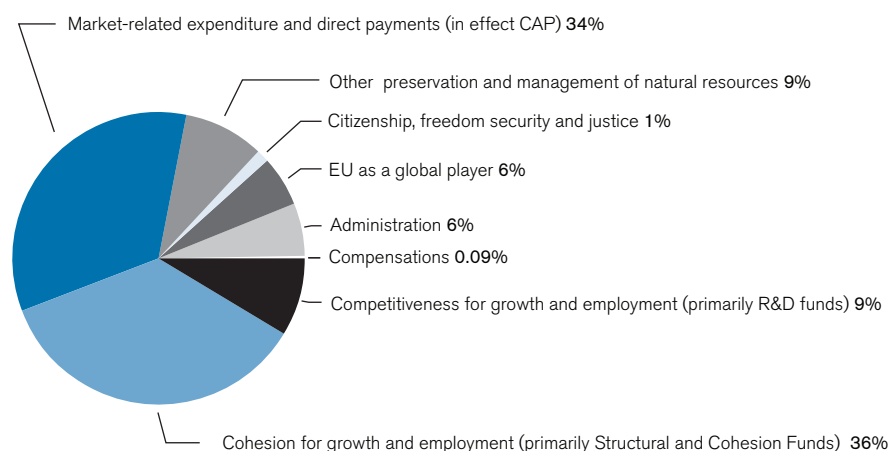
European Union the world’s most ‘competitive and dynamic’ knowledge-based economy by 2010. Hubris aside, the inspiration behind the strategy was a sense that the European economy was falling further behind the United States in key areas. Rather than relying solely on central, European Commission-initiated directives, national governments needed to implement radical reforms themselves in order to cope with emerging challenges not only from the United States, but also from other parts of the world such as India, Southeast Asia and China.³⁰

The fact that the Lisbon Strategy needed to be re-launched in 2005 reflected a failure on the part of member states initially to act on the need for sustained in-country effort over many years to effect profound behavioural as well as structural changes. The inability to agree on an EU-wide patent system or to further open up Europe’s energy markets, for example, all rested upon national prejudices and preferences for market protection rather than openness. The ‘European Union’, ‘Brussels’ or the ‘Commission’ could not be blamed for failings which lay at the door of the EU’s constituent nations.

The Lisbon II strategy of 2005 has adopted a more pragmatic approach which should pay better dividends. Progress has been achieved in a number of discrete areas, including broadband connectivity, the greater ease with which companies can be set up and financial services deregulation. Most member states have taken seriously their obligation to produce comprehensive and coherent reform programmes, following guidelines developed at a European level, and success in lowering unemployment rates, in particular, has been noted. The process of developing national strategies and allowing the Commission to monitor their progress has become much more systematic.

Nevertheless, the slow pace of adopting national reforms in a number of countries has placed the EU at a disadvantage *vis-à-vis* its main global economic competitors. National-level resistance has also limited the deepening of the Single Market in the services sector. Despite accounting for over 60% of EU GDP, the service sector remains riven by national protectionist laws and practices which limit much-needed market innovation

Figure 5: EU financial framework 2007-13



Source: EUR-Lex (www.eur-lex.europa.eu)

and price reduction, from law and financial services to transport and power distribution. The agreement of the Services Directive in 2006 was a step forward, but a much more hesitant one than was needed.

Finally, insufficient political effort is being applied to tackle the most worrying structural problem facing the EU – its inevitable and pronounced population decline over the next 20–30 years. Towards the end of the next decade, the EU faces the worrying combination of rising longevity and a current fall in birth-rates which will reduce the number of working-age individuals in nearly all EU countries, most emphatically so in Germany, Italy and several of the central and east European members.

The steps being taken today to reform pay-as-you-go pensions systems and generous state-funded health systems do not yet sufficiently take into account the severity of the inversion of Europe's demographic pyramid. And the resistance to current levels of immigration into the EU from third countries means that a massive influx of foreign workers and families is not a credible option. The Lisbon Strategy target of raising employment helps, but, without tackling this impending crisis in a serious manner over the next five to ten years, undertaking structural reform or deepening of the Single Market will have only a limited impact on the future economic fortunes of EU member states.

Reforming the EU budget

Initial attempts to reform the EU budget have been a positive if still limited step to improve the EU's collective performance. The need for a thorough review was agreed when the budget was settled in December 2005 during the British EU presidency. Having launched a wide-ranging consultation, the current European Commission is expected to publish its own reform proposals in the spring of 2009 and hopes to have finished the review process before its mandate comes to an end later that year.

The Common Agricultural Policy (CAP), from the outset the single largest item of expenditure in the EU's budget, has been subject to significant reform in recent years and has fallen back substantially as a proportion of the budget, from over 50% in the late 1990s to around 34% (see Figure 5). Price support payments which inflated production have given way to single payments to farmers not only for income support but also for rural and sustainable development. Export subsidies have also been cut back. The CAP is less of the monster that it once was but remains a flawed policy.

The EU's budget is a small percentage of overall gross domestic product. In 2008, it is set for €120 billion – around 2% of the public spending of EU member state governments and other levels of government taken together and 1% of the EU's aggregate gross national

income (GNI). Over the last ten years, growth in the EU budget has been slower than growth in public expenditure among the member states. Nevertheless the amounts spent in the budget on promoting two of the key areas of the EU's activity vital to its future prosperity and security – funding on cross-border EU basic R&D and on coordinated external policies – remain noticeably low in relation to other areas.

British policy choices: from Single Market to single currency

Britain has been a long-standing supporter of a more deregulated and open European market, the consensus view being that a more competitive and open EU will also help make Britain more globally competitive.

This does not mean that Britain has only a European route to its future economic success. It is interconnected globally – notably to the United States and Asia – through its trade patterns and flows of inward and outward investment. But the EU is Britain's regional 'home market', accounting for a majority of its trade and serving as a critical magnet for the FDI that it attracts. And Britain's membership of the EU as one of the world's three largest markets and cohesive international economic actors gives it the opportunity to help write the rules that will define tomorrow's global economic environment. The case for an open EU now needs to be argued with renewed vigour, given the rising pressures for economic protectionism across the EU. With this principle in mind, British governments should focus their efforts in several key areas over the coming years.

Completing and expanding the Single Market

In terms of raising British and overall EU competitiveness, Britain needs to keep up the pressure for a further opening of intra-EU trade and investment.

- In this context, further opening up the market for the provision of services, from professional services to utilities and financial services, should be a central priority, given the importance of this sector for

future European growth and also Britain's own competitive strengths across this broad area.

In the area of financial services, for example, the City of London has been instrumental in pushing forward efforts to establish a globally competitive single European financial area which it also sees as improving its own competitive position *vis-à-vis* the United States. As one of the main venues in the world where the euro, yen, dollar and pound meet in the market, the City works to the economic benefit of both Britain and Europe as a whole. However, we should not forget that, in an increasingly competitive market for providing global financial services, the dominant position of an existing financial centre like London cannot be taken for granted. Despite its advantages of geography, time zone and regulatory and tax regimes, Britain could lose the prize of being Europe's leading international financial centre if the pace of financial market opening in Europe slows or if regulatory changes are taken in the European context that limit the City's current agility and dynamism (this is not to downplay, of course, the importance or necessity also of effective domestic regulation in the light of the Northern Rock fiasco).

‘ Britain has a strong ally in the European Commission to tackle those areas where the supposed defence of social welfare is in fact a screen for national protectionism ’

While there is resistance in some EU countries and among certain interests to liberalizing services, especially those that have a social dimension to them, such as health-care, energy provision and postal services, Britain has a strong ally in the European Commission to tackle those areas where the supposed defence of social welfare is in fact a screen for national protectionism. Here, following the difficulties in passing a comprehensive services liberal-

ization package, Britain must support the Commission in using competition policy as much as Single Market legislation to help open service markets on a sector-by-sector basis.

In addition, Britain should work with the Commission to resist the passing of EU-wide or national laws that would restrict the ability of other countries to invest on the grounds of national security, unless such legislation is very narrowly circumscribed and carries a high degree of transparency.

- Britain should also continue to guard against, and oppose where necessary, those EU-wide initiatives which are designed primarily to protect existing national economic deals, budgetary priorities and social contracts. We do not believe, for example, that it makes sense in today's and tomorrow's global economic environment to try to set common rates of corporate tax across the EU.

To be sure, we need to guard against the practice of EU countries setting favourable rates that distort the Single Market by inducing companies to declare profits in tax-friendly jurisdictions, even though they might have been earned elsewhere in the EU. It could also be worthwhile to try to harmonize the wide range of national corporate tax bases. Moreover, there are clearly areas where the establishment of EU-wide social policies has demonstrated to those who are employed that the creation of a single market does not mean a race to the bottom for workers' rights. Examples include the EU's directives on equal pay and equal treatment for women, as well as workers' rights to paid holidays.

More generally, however, the strength of the EU will come from the interaction of its different systems of micro-economic governance, including corporate tax policy, that are each exposed to the pressures and constraints of national democratic politics and global economic competition. Britain should bring to the EU social policy debate an approach that emphasizes individual empowerment and improved opportunities for finding new employment (enabling workers to carry personal pensions across the EU, for example).

In addition, while we believe it should remain the sovereign prerogative of national EU governments to

establish welfare programmes that support their workers or citizens in whatever way they see fit (including, for example, by setting national minimum wage levels, unemployment benefits and hiring and firing practices), we do not believe that there is a good case for trying to set these as new protections across the whole of the EU under the argument of social solidarity.

- The criterion should be whether new EU social proposals would be essential for the Single Market to operate fairly without discrimination, not the pursuit of harmonization for its own sake.

In our opinion it is reasonable, therefore, that an Estonian company that hires Estonian workers to operate in Spain should abide by Spanish employment practices. However, it is up to the Estonians to determine the levels of protection (beyond those laid down in EU-wide legislation) that pertain to their own domestic labour market.

EU international economic relations

Protectionist pressures are growing internationally, driven not only by slowing global economic growth, but also by a new agenda of using trade barriers as proxies in the upcoming conflict over who should bear the larger burden for adapting their economies to a low-carbon future.

- Britain should continue to encourage an open and free market approach to the international economic relations of the European Union in the coming years.

As a member of a highly integrated customs union, the British government has already devolved to the European Commission the responsibility for negotiating trade deals on behalf of the EU as a bloc. Fortunately, the British interest largely coincides with the approach of the European Commission, as well as a number of its EU partners, in seeking to open up global markets for service exports, protecting intellectual property and facilitating market access for manufactures. And the need to curb the kind of EU support for European agriculture that distorts trade is already accepted in the framework of the current

Doha Round of WTO negotiations, even if the final parameters of this deal remain elusive. A priority must be to complete the Round, while recalling that it started life as the Doha *Development* Round, and that Britain is a firm supporter of the aims articulated in the Millennium Development Goals.

One area where Britain could play a leading role that would carry important implications for its own national competitiveness is in using the power of access to the EU's integrated market to help define the standards and regulatory controls applied to products and services that flow between the EU and other key markets. In a world where tariff barriers to trade continue to fall, major trading partners such as the United States, Japan and China are able to use non-tariff barriers such as safety standards and limits on foreign investment to deny access to British and other EU countries' products and services. The EU, of course, does precisely the same in many areas.

We believe that the British government, which has been a leader in past efforts to break down barriers across the Atlantic, should put its political muscle behind the Framework for Advancing Transatlantic Economic Integration between the United States of America and the European Union, which Angela Merkel, as holder of the EU Presidency, signed with George W. Bush in April 2007 to lower regulatory barriers to US–EU trade and investment.³¹ Such initiatives have invariably stalled in the past in the face of the very different regulatory oversight systems which operate in the US and in the EU. But a concerted British and German push in this area, which recognizes the need for transatlantic cooperation ahead of the emergence of a more assertive China in the area of standards and regulations, is urgently needed and could appeal to a new US administration.

- As the OECD calculated in its 2005 study on US–EU trade, the lowering of such non-tariff barriers could give an enormous boost to economic growth on both sides of the Atlantic.³²

There remain two perennial economic questions – the currency and the EU budget – which this and future

British governments will need to consider carefully in their relations with the EU over the coming years.

Britain and the euro

First, and most importantly, will Britain best serve its long-term national economic interest by keeping its own currency? And, as a related question, can Britain play an effective and constructive role in areas of the EU's future economic policy we have described above from its position outside the Eurozone?

Problems of convergence

'When the time is right' has been a much used and very convenient formula for Britain in relation to its attitude towards monetary union (and, indeed, in other contexts). As noted above, the British economy did not suffer directly from the government's decision to remain outside the single currency in 1999, and there remain a number of strong reasons why many are sceptical about Britain giving up its own currency. The strongest is the continuing uncertainty over whether Eurozone economies will start to show greater convergence in terms of business cycles, growth rates, inflation and unemployment than they have done in the last ten years. Continuing divergence, while causing strains, has not prevented the Eurozone from working as a single monetary unit. But it has complicated the attempts of the European Central Bank (ECB) to set appropriate interest rates for economies whose performance has been as diverse over the past five to ten years as Spain's and Germany's.

Greater economic convergence could be assisted by overcoming the existing tensions between some members' fiscal policy and the ECB's monetary policy, either through better coordination or through closer informal political integration among Eurozone members. Convergence could be a slow process, however. While Germany has used the strength of the euro as a spur to domestic reform, Italy, which has been slow to reform so far, has seen its competitive position *vis-à-vis* Germany decline by up to 30%. The 'reformist divergence' between the slower and faster structural reform agendas of many Eurozone countries could lead to further political tensions in the future. Greater divergence would make it significantly more difficult to set

interest rates at the appropriate level for all countries. And this divergence could be exacerbated by other member states with different macroeconomic profiles joining the single currency over the next ten to twenty years.

As Britain enters a more turbulent economic period domestically and internationally, therefore, it is entirely possible that an independent Bank of England will be in a better position to help stabilize the British economy than an independent ECB which must continue to manage the competing priorities of structurally diverse Eurozone economies.

A changing context

The recent relative improvement in Eurozone performance could be partly attributable to euro members harnessing the benefits of a single currency along with greater convergence of their economic policy-making. Moreover, it is not unrealistic to believe that the pressures of being in the Eurozone will accelerate the pace of reform in countries which have been reluctant to confront the need for it – indeed, this may now be what is happening in France. Greater long-term economic convergence between members of the single currency would improve the attractiveness of the Eurozone for Britain since it would diminish the risks of a ‘one size fits all’ ECB monetary policy being inappropriate for Britain. Interestingly, Britain has stood in the middle of the ‘euro pack’ in terms of its overall macroeconomic performance (deficit and budget levels, interest rates and inflation) as compared to its Eurozone counterparts over the last ten years.

While this convergence has yet to materialize, there are also two other important discontinuities which this and future British governments must respond to in terms of their thinking about Britain and the euro.

First, Britain could find that the costs of maintaining a sovereign national currency in a world of a small number of mega currencies might increase. As noted above, the euro is already the second most important international reserve currency and this role can be expected to expand. Because it is pulled by both major currencies, the pound will be vulnerable to volatility induced by competition between them, and this may prove to be destabilizing for the British economy.³³ For British policy-makers, this

makes it difficult to judge how to set interest rates so as to ensure economic stability.

Currency movements affect Britain’s competitive position in different ways. While the dollar was strong in the early years of this decade, sterling also rode high against the euro, with an adverse effect on British competitiveness. Indeed, for much of the last decade the UK has had a sizeable current account deficit, despite the contribution of North Sea oil and gas. Now, with North Sea output tailing off, the pressure on the balance of payments will be accentuated and it may be that the strong pound of the oil years is giving way to currency weakness. A weaker pound might help competitiveness in the short term, but risks fuelling inflation, with damaging medium-term consequences for the UK’s competitive position. Business leaders put a premium on stability, whether in terms of inflation or the exchange rate, and this is a factor that ought to enter the equation.

‘ Britain could find that the costs of maintaining a sovereign national currency in a world of a small number of mega currencies might increase ’

The credit crunch has shown the value of being inside the safe haven of the euro currency bloc, and the turmoil that might have arisen had there still been separate currencies can only be imagined. The stability offered by the euro would be especially welcome if, over the next ten to twenty years, British economic performance deteriorated relative to that of the Eurozone for a sustained period of time.

Second, as noted above, the Eurozone will most probably expand over the next ten to twenty years to incorporate the vast majority of other current members of the EU. Even Denmark, which is the only other country to have a formal opt-out from the single currency, now seems to be reconsidering. If Britain were to remain outside in a minority of one, two or three, there could be political and economic ramifications.

In particular, it is inconceivable that there will not be a deepening of the consultation and coordination among Eurozone governments of their macro- and, possibly, their microeconomic policy-making. Chapter 3(a) in the Lisbon Treaty gives the Eurogroup – the body that brings together Eurozone finance ministers and central bankers – new powers to coordinate their economic policies, and would embrace both fiscal and structural policies. Whether the provisions of the treaty come into force or not, the commitment to increased coordination is in place. An expanded Eurozone would give Eurogroup members the capacity to strengthen more formally their dominance of Ecofin (the Council of Economic and Finance Ministers). This is especially important because Ecofin can take decisions by majority voting in a number of important areas, including on whether to declare a member state to be in a position of excessive deficit.

Britain might find, therefore, that its capacity to help define the EU economic policy agenda from outside the Eurozone, even in areas of great British interest such as financial market regulation, might diminish in the coming years.

Next steps for Britain on the single currency

Given the competing risks of entering or of staying out of the single currency, this Commission takes the following position:

- First, we do not support the idea that Britain should give up the pound simply to avoid ‘losing influence’ in Europe or to ensure that it is not left out of the euro institutional bandwagon, even if the Eurozone contains new forms of political-economic coordination. Many false alarms on this point were sounded in 1999, though admittedly there is now a need to be alert to new risks.

The key issue here will be to assess the implications of such developments for Britain’s economic interests. It is entirely possible that strong British national economic performance will enable Britain to continue arguing for its economic vision for Europe from outside the Eurozone, whereas an under-performing Britain inside the Eurozone will gain minimal additional benefits for its economic future.

- Second, we support the current government position – originally stated by Chancellor Gordon Brown in June 2003 when he presented the results of the comprehensive exercise to assess the ‘five tests’ on joining the euro – that membership in ‘a successful single currency’ could be of benefit to Britain. We also agree that we should not make the decision on whether or not Britain should join the euro in the future a matter of principle. However, the Chancellor signalled in 2003 that the decision would be reviewed annually. We are concerned, therefore, that in these times of currency and economic turmoil, the question has become all but invisible. Given the economic context we have described above, we recommend that the British government now keep the decision under regular review.

The Eurozone still suffers economic divergence between its members and lacks the financial means and political structures to conduct a truly convergent EU-wide economic policy. This situation is unlikely to change soon. However, Britain might find that the destabilizing effects of an extended period of currency volatility in the future outweigh the macroeconomic risks to the British economy of transferring control of interest rates to the European Central Bank.

- Third, therefore, we should not rely solely on a narrow interpretation of the five economic tests initially laid out by Gordon Brown in 1997 to assess the costs and benefits to Britain of joining the single currency. We should recognize that deciding whether or not to join the euro will involve a political as well as an economic judgment about the net benefits for the UK economy. British ministers should be engaging the British public in a mature discussion of the risks and opportunities that this decision could entail.

The conservative government of John Major negotiated at Maastricht the right to ‘opt in’ to the single currency precisely for these reasons. Under future national or global economic conditions, Britain may need to reconsider its position and appeal to the pragmatic self-interest of the electorate over giving up the pound.

The rebate debate and the future of the EU budget

The second perennial question for British governments concerns the annual rebate which Britain receives on a portion of its net contribution to the EU budget, which Prime Minister Margaret Thatcher secured in 1984.

- While recognizing the intense political debate over this issue, we believe that Britain should reaffirm an often overlooked part of the policy set by Margaret Thatcher at the outset: that the rebate should last only so long as the underlying problems that gave rise to the inequity remain unresolved. The principle of EU finance should be that countries of like prosperity should pay roughly the same proportion of GNI into the EU budget in net terms – that is, the difference between payments into the budget and receipts from it.

Even after the famous rebate, Britain has been a consistent net contributor, whereas some other countries of similar levels of per capita income have been net beneficiaries. However, in the current seven-year framework, Britain and France will, for the first time, have broadly similar net burdens. It should also be recognized that, whereas only Germany and the UK were net contributors up to the beginning of the 1990s, several other countries now make larger net contributions than Britain does. While the UK is the only country with a formal rebate, there has been a proliferation of other ‘corrections’ designed to abate the net contributions of others. The upshot is an increasingly messy system.

If there is a thorough overhaul of the EU budget and, in particular, further significant reform of the CAP, then the justification for the British rebate may be removed. Or it may finally prove possible to have a system genuinely applicable across the EU which relates a member state’s net contribution more closely to its ability to pay. The overall financial arrangements of the EU are not due to be negotiated again until around 2011 and the last thing the EU

needs is to trigger prematurely a difficult and fraught negotiation. Nevertheless, the review currently in progress should be seized on as an opportunity to rethink the fundamentals, as opposed to the precise arithmetic, and to focus the EU budget more on priorities and policies for the future and less on those of the past.

The achievement of a more equitable budget system would put Britain in a far better position to argue how EU public finances should be reformed to promote genuinely European objectives, policies and ‘public goods,’ rather than being on the defensive about ‘money back.’

- Increasing the portion of the budget that is applied to EU-wide, cross-border research and development spending or actions to develop alternative energy sources, for example, should be a priority in this context. Britain and its EU partners need to find new ways to create centres of excellence that draw together the best minds and practices from across Europe, in order to improve standards of innovation and invention across Europe. And significantly larger budget amounts for external action, internal security coordination and cross-border European initiatives to combat climate change would reflect a forward-looking agenda for the EU.

Overall, Britain’s future economic competitiveness is strongly tied to the success of the EU as a whole. Whether in the area of the Single Market or international trade, Britain has good ideas and experience to bring to the European debate. As champions of an open Europe, British governments must have the courage to fight resurgent economic populism and protectionism in the EU. The long-term strength of Britain’s own economic performance, as much as its entry or not into the single currency, will be the most important determinant of its future influence in these debates.

6. Building a European energy market

We turn last to a specific policy area – energy security – that ties together many of the themes discussed in previous sections and that stands out as another policy area where closer EU coordination would undoubtedly be in British interests.

Britain's new energy reality

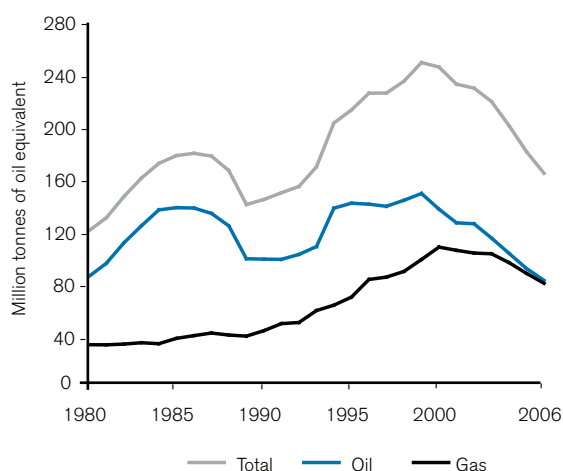
The UK has spent the last thirty years or so in the enviable position of being largely self-sufficient in oil and, more

recently, gas thanks to its access to supplies from the North Sea. It also overcame its increasingly expensive dependence on domestic coal production for power generation through a shift to imported coal, continuing reliance on its domestic nuclear power plants and, in the last ten years or so, a substantial programme of investment in new gas plants.

The next few decades will not be so favourable for British energy needs. In fact, the country is in the early stages of experiencing a fundamental set of challenges to its energy security – challenges which carry real potential repercussions for both its economic prosperity and its national security. Consumers must expect significantly higher bills, not just because of higher world prices for hydrocarbons, but also because of the need to switch to more costly alternative sources as part of finding solutions to climate change.

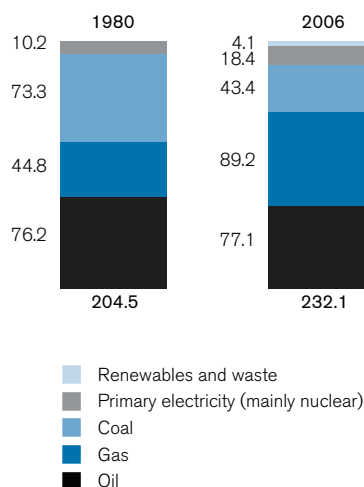
First, supplies of oil and gas from the North Sea are falling steadily as reserves there become exhausted (see Figure 6). If recent trends continue, production could fall from three million barrels of oil equivalent (boe) a day now to around one million boe a day by 2020. The UK first achieved a surplus on oil trade in 1980, but by 2005 it had again become a net importer of oil. In 1993, it began exporting gas and became a net exporter in 1997. But since 2005 it has again become a net importer of gas. By 2010, imports could

Figure 6: UK Continental Shelf production, 1980 to 2006



Source: UK Energy in Brief 2007, Department for Business, Enterprise and Regulatory Reform (BERR)

Figure 7: Inland energy consumption, 1980-2006 (mtoe)



Source: UK Energy in Brief 2007, Department for Business, Enterprise and Regulatory Reform (BERR)

account for up to a third or more of the UK's total gas demand, potentially rising to around 80% by 2020.³⁴

At the same time, Britain's extensive investment in gas-fired power plants (see Figure 7) has roughly coincided with a large increase in the international price of gas alongside the price of oil. This price rise shows all of the signs of persisting well into the future given two key structural factors: first, burgeoning demand for oil and gas in Asia and other parts of an increasingly wealthy developing world; and, second, a lack of investment by energy-producing countries in the infrastructure necessary to raise production levels to meet the rises in demand.³⁵

One solution to this new environment would be to significantly increase Britain's reliance on coal-fired power plants. However, given the fact that carbon capture and storage (CCS) will not be a realistic strategy until perhaps 2020–30, this would run counter to the country's commitment to reduce its CO₂ emissions and appears, therefore, to be a politically very difficult option, at least at the moment. Any solution to Britain's energy needs must now take into account the country's national commitments and international leadership role in reducing the emissions associated with climate change, especially through near-term investment in CCS.

Another potential solution from an emissions perspective and in terms of reducing reliance on external energy supplies will be to try to increase the amount of power generation produced from Britain's nuclear power plants. The problem here is that most of the plants were built in the 1960s and 1970s and therefore are largely scheduled for closure in the next few decades. No new nuclear power plant has been built in Britain within the last ten years. Sustaining current levels of nuclear-powered energy in the UK will be a major challenge in itself, setting aside the likelihood of increasing these levels as a proportion of Britain's overall energy needs. Nonetheless, starting to build fresh nuclear capacity will have to be part of Britain's long-term approach.

A further alternative is to carry out a major programme of investment in renewable sources of energy, such as wind, tidal and solar power. It is estimated that around £1 billion was either invested or committed to new UK renewable projects in 2007. As noted in Section 2, in order

to assist in meeting its 20% GHG reduction target, the EU has set itself a binding target which envisages 20% of energy coming from renewable sources by 2020. This target will be apportioned between member states depending on their current usage and renewable resources. In the case of Britain, it is anticipated that a 15% overall renewables target will be required by 2020. Given the lack of progress in other areas, this translates into a wind power share of around 35–40% in electricity generation by 2020 – as opposed to under 5% now. This will require a considerable scaling up of current plans, and even the most optimistic scenarios show that renewables will most likely deliver only about 11% of UK electricity supplies by 2015, and at considerable cost.

Britain has at present around 75GW of electricity generation capacity to meet a winter peak demand of about 63GW. But substantial investment in the next two decades is needed in order to fill both demand and the growing gap that will be left in the market by the closing of old coal, oil and nuclear power stations. The Department for Business, Enterprise and Regulatory Reform has estimated that 22.5GW of existing power capacity may close by 2020.³⁶ Even if Britain meets its existing targets for a switch to greater use of renewable energy and improved energy efficiency and conservation, new capacity is still likely to be needed.

[Britain's Russian gas dependency](#)

Having built up its gas-powered energy infrastructure heavily in the last decade and given commitments to reduce its CO₂ emissions, Britain must recognize that gas is likely to be the principal means of filling this gap. As a result, it will be heavily dependent on gas imports for the bulk of its power generation over the next couple of decades.

This brings Britain face to face with the risk of having to acquire more expensive energy imports to meet the country's power consumption. In itself, this need not necessarily be a cause for alarm. During the 1980s, Britain imported around 20% of its gas supply from Norway via the Frigg pipeline, and, during the 1960s and 1970s, Algerian liquefied natural gas (LNG) was imported at Canvey Island on the River Thames. Today, however, the marginal gas supplies that

Britain will need to make up the difference between sufficiency and inadequacy will come from Russia – specifically from its monopoly supplier, Gazprom. And, by dealing directly or indirectly with Gazprom, Britain and other European states are dealing with the Russian state.

Alternatives to Russia's role as marginal supplier of gas are limited.

Norway, Europe's largest gas producer, has little or no incentive to speed up the depletion of its energy reserves or to engage in price competition with Russia in order to gain additional market share. In fact, Statoil, Norway's state-owned energy producer, is deepening its relations with Rosneft and Gazprom, Russia's two largest, state-controlled energy companies, rather than entering a period of market competition with them.

For its part, *Algeria* is already a good supplier of gas to Spain. Expanding its supply networks and agreements further north will not be easy. Significantly, Russia is strengthening its corporate links with Algeria to ensure that Russian gas pricing strategies are not unduly disrupted, and has recently agreed a deal whereby it will seek to pipe Nigerian gas all the way through Libya to southern European markets.³⁷ And increases in gas and oil exports from other North African producers, such as Libya itself, will be easily and rapidly soaked up by close Mediterranean neighbours to the North such as Italy.

The Caspian region is often held up as Europe's key alternative source of gas supplies. However, it is in no shape to serve as a major alternative supplier to Europe or Britain in the near term. Currently, almost all of its oil and gas supplies flow north through Russia. The proposed Nabucco pipeline offers the main alternative route into Europe. The Russian South Stream pipeline involving Hungary and Serbia, and doubts about the availability and volume of gas supplies from Turkmenistan, undermine this option considerably. There is also the matter of how to traverse the Caspian itself, given the legal disputes over its status as a sea or a lake.

Importing LNG remains a more expensive alternative to piped gas, although there are now two large LNG import terminals on the Isle of Grain and Teesside, with a further two under construction. Within ten years a quarter of peak supply capacity might be met from LNG sources.

Whatever the scenario, British dependence on imported gas for power generation is about to increase significantly. Unlike many of its continental European partners, Britain has not signed significant long-term, fixed price gas supply deals with major gas exporters and must rely on increasingly volatile and expensive sources from the spot market. British governments therefore face a number of pressing questions. How will the country secure the necessary supplies of energy for its economy while not being vulnerable to sudden price volatility? How does it avoid creating potentially risky new levels of dependence on unpredictable suppliers? And in doing so, how does it avoid breaking its international commitments to tackle the threat of climate change?

For the last few decades, the idea that Britain would need to team up with other EU member states to meet its energy needs would have been fanciful. Today, however, Britain's competitive modern economy cannot rely on an independent approach to energy. Nor can Britain handle Russia's dominant position within European energy markets alone. In its relationships with key energy producers in Russia, former Soviet Central Asia, the Middle East and North Africa, neither Britain nor any other European All EU members are vulnerable to price shocks, supply interruptions, instability in the countries on whose energy resources they depend, and, potentially, to outside political blackmail. As a result, the health and security of the British economy is dependent on factors over which Britain has comparatively little influence.

A better coordinated European energy strategy will need to be an important part of Britain's energy policy mix.

The EU as part of the answer

The starting point for this coordination must be the recognition that Britain and almost all of its EU counterparts face similar challenges to meeting their future energy needs, even if some countries, such as France with its heavy reliance on nuclear power, have significantly different mixes in their sources of energy.

European responses to date

Overall, EU member states, taken collectively, currently import about 50% of their gas and 80% of their oil needs. Some 45% of the EU's oil imports come from the Middle East, while around 40% of its gas imports originate from Russia, 20% from Algeria and 25% from Norway.

Total import levels are projected to increase over the coming couple of decades (see Figure 8). This has led to rising anxiety in all EU capitals about the implications of growing energy import dependency on their national economic security.

Currently, European countries are pursuing a range of diverse national strategies to protect their future energy security. Some are trying to strike long-term national supply deals with key suppliers, as Germany, Italy and a number of central European countries are with Gazprom for future gas supplies and Spain has done with Algeria.

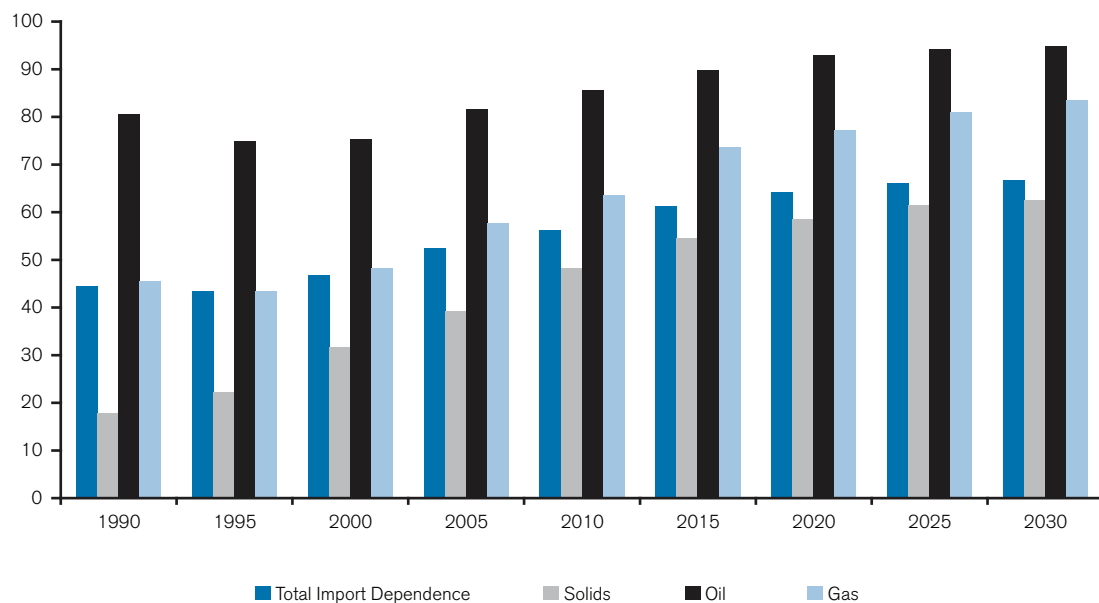
Despite nearly two decades of liberalizing European energy markets – primarily through European directives, national initiatives and the privatization of national state-owned energy companies – most European countries are also now trying to protect existing national energy champions or to build new ones. These will not only dominate national power generation and energy distribu-

tion, but will also have the market size to strike favourable supply deals with outside producers while offering downstream and upstream investment and technology for those suppliers in return.

At the same time, as noted in the second section, all European countries have made far-reaching commitments nationally and in the EU context to achieve greater energy efficiency, to meet CO₂ emission reduction targets and to increase the size of their renewable energy industries. However, EU member states are far from having reached agreement on how they will meet these targets, either collectively or individually. Attitudes to the use of nuclear power as a means to reduce carbon emissions, for example, differ substantially from country to country. And neither EU governments nor their citizens or businesses have factored into their policies, personal finances or business plans the sorts of rapid hikes that have occurred recently in energy prices. These price increases, while starting to change and lower patterns of energy consumption, and hence CO₂ emissions across the EU in the short term, are leading to a serious political backlash that might undermine long-term governmental carbon reduction strategies.

Achieving energy efficiency is complicated and requires action across a significant range of sectors, not

Figure 8: Import dependence of the EU (%)



Source: PRIMES, published in *European Energy and Transport – Trends to 2030* (update 2007), 2008, © European Communities.

just energy. Not all of the economic energy-efficient measures will be produced by the market. Intervention is needed to set standards (for electronic goods, buildings, transport etc.) and enforcement mechanisms. Environmental policy has already been one of the more successful areas of EU policy: EU-wide standards have now been agreed on clean drinking and sea-bathing water as well as on air quality and use of pesticides, helping deliver benefits to British and other EU citizens. The EU could play an equally important role in coordinating energy efficiency targets.

At this stage, and despite its importance, the European Commission's 2020 energy efficiency legislation has not introduced a binding target, as is the case for renewable energy, but rather sets objectives for member states along with an action plan for meeting the energy efficiency target. Sadly, this downplays the importance of energy efficiency. The resulting financial savings could potentially fund more expensive renewable and other sustainable energy solutions that will be necessary to further reduce emissions and promote energy security.

The renewable energy target implies a more than fourfold increase in share in the EU's use of such energy by 2020. Within the directive is a separate requirement that 10% of liquid transport fuels come from renewable sources.³⁸ If these two targets were achieved they might more than meet the EU's current 2020 GHG reduction target and also assist in improving energy security by both diversifying energy sources and reducing dependency on imported energy.³⁹ The likelihood of these targets being met, however, is slim.

Building a more physically integrated and better coordinated EU energy market

As major importers of energy in an increasingly politicized world of both climate change commitments and energy supplies, where suppliers have the benefit of ever-increasing levels of global energy demand, most EU countries are vulnerable to shifts in price and to changes in the market arrangements proposed by their energy suppliers. Like Britain, almost all EU countries are also well behind in investing in energy infrastructure, from oil refineries to power stations.

The logical answer for EU governments is to find ways of banding together to minimize their vulnerability to outside market pressures and so as to negotiate the best possible deals for their longer-term energy security.

Two broad strategies stand out in this regard. The first is to create a more physically integrated EU energy market which would have the potential to lessen EU member states' vulnerability to supply disruptions and reduce GHGs by sharing capacity and spreading risk. It should be recognized that the EU is currently made up of national energy markets which have limited bilateral connections with each other. As a result, each country pays the significant cost of carrying spare capacity while running larger risks than necessary to its security of supply.⁴⁰

‘Significant efficiency gains could be achieved, principally through greater interconnectivity of national electricity and gas grids’

If, however, EU governments were to think of their energy markets as inextricably interlinked, significant efficiency gains could be achieved, principally through greater interconnectivity of national electricity and gas grids. An important additional factor is that advances in information technology enable the management of regional energy markets today in ways that were impossible in the past. Partly as a result, the natural domain for European energy companies has moved from the national to the regional European level.

Not only would this allow Britain to gain better access to the continental market, but it would also allow a nuclear-dependent France to supplement its energy needs from its EU neighbours, for example during heat waves, which can seriously constrain the generation capacity of nuclear power plants. A more interconnected European energy market would also develop a European framework for the strategic storage of gas reserves – much as exists currently for oil reserves under the auspices of the International

Energy Agency (IEA) – whose release would be determined by the collective benefit of European markets as a whole rather than being held back to protect specific national needs.

A more interconnected European energy market and one that approaches reserves from a collective as opposed to a purely national perspective could iron out some of the excessive price differentials for gas and electricity that have surfaced during recent supply shortages or demand peaks, while also giving European leaders a better chance to stand up to politically motivated threats to cut back supplies.

From the perspective of combating climate change, this approach would increase governmental comfort with the transition to lower-carbon-emitting gas-powered generation. It would also help smooth the production and demand volatility that will accompany the introduction of more renewables, which are intermittent generators.

The second approach is for the EU to speak with one voice in negotiating the terms for its external energy supplies. This option will be tied closely to its ability to link up its internal energy market. Just as the European Commission took on responsibility for representing all EU member states in international trade negotiations after the creation of the customs union, so the option of using the leverage of the EU energy market in negotiations with outside suppliers will depend largely on the creation of a more open internal energy market. As we discuss in more detail below, this is an idea which needs to be considered now, without delay.

Integrating Europe's energy market

Right now, Britain stands out in Europe as being one of the countries least prepared for the realities of the new global energy market. It has lost its special status as one of the EU's few members that are largely self-sufficient in energy. Partly as a result of its past status, it has not been at the forefront in striking special bilateral deals with outside energy suppliers such as Russia. Instead, it is trying to recalibrate the mix of its domestic energy capacity and infrastructure to meet the pressures of the new global

market. As important as these steps are, the UK energy crisis in the winter of 2005 was a stark warning that the British government does not have the luxury of time for the effects of this recalibration to be felt. Britain must combine the steps that it is taking nationally with an urgent commitment to helping build a more interconnected European energy market.

Britain need not be a follower in this process. It has a great opportunity to push for the development of the sort of EU-wide energy market that would benefit its own economy as well as those of its EU counterparts. The British government has already played a leading role in the creation of the EU Emissions Trading Scheme, and has been one of the architects in setting common and binding EU GHG targets in order to tackle climate change. And, during the British Presidency of the EU in 2005, it put forward a number of important ideas at the Hampton Court EU summit on ways to create a more integrated EU energy market. Now, Britain has much to gain from following through on these ideas.

Finding the right EU energy partners

This will not be an easy process. Britain's two key partners in moving the agenda forward should be France and Germany. However, both countries bring a very specific perspective to the greater integration of EU energy markets. They want to ensure that this process leads to the enhancement of their national energy champions, EdF, Gaz de France, E.ON and RWE both for simple commercial reasons and in order to strengthen their national hand in defining the future structure of Europe's energy market. Consequently, they have been opposed to the ownership unbundling of the grids from the integrated energy utility companies.

For its part, Germany has the potential to be the gas hub for a more integrated European gas market. However, German political and business leaders have assiduously cultivated a 'special relationship' in the energy field with Russia. Leading energy companies such as E.ON and, through E.ON, Ruhrgas have close business relationships with Gazprom, including cross-share ownership, which have involved signing long-term contracts with Gazprom to supply gas into the German markets. For many in

Germany, closer energy relations between Russia, Germany and the EU are the surest route to building a strategically interdependent relationship between Russia and Europe. At the same time, these relationships offer the opportunity for Germany to strengthen its own national energy security.

‘ So long as Germany is seen to be prioritizing its own energy security interests over all other considerations, then other EU member states which have the option to do so are likely to follow suit ’

The blending of these two objectives was epitomized by the agreement to construct the Baltic pipeline between Russia and Germany and the decision by former Chancellor Gerhard Schröder to chair the company overseeing the construction of the pipeline which he approved just before leaving office. The pipeline gives Germany direct access to Russian gas supplies and removes some of the risk posed by receiving the bulk of its supplies through Ukraine. The political strength of this agreement is further reflected by the fact that, should it be completed, the pipeline is likely to come ashore in Chancellor Angela Merkel’s constituency.⁴¹

So long as Germany is seen to be prioritizing its own energy security interests over all other considerations, then other EU member states which have the option to do so are likely to follow suit, just as Austrian, Hungarian and Italian companies have done with the South Stream project and the Gazprom-OMV deal on the Baumgarten gas hub in Austria.

Engaging Germany

The central challenge for British policy-makers, therefore, is to find ways to involve Germany in sharing an active role in

building a more integrated European energy market. German policy-makers are not insensitive to the contradictions in their own positions. It is hard, for example, for Germany to be a leading proponent of a more coherent European external policy and, at the same time, allow the energy dimension of this policy to be absent. Germany’s ability to strengthen its relations with its central and east European neighbours will also be limited by its taking an overly self-interested approach to its energy security when these countries see dependence on Russian energy through an entirely different prism – one coloured by memories of the control that the Russians exerted over them partly through the manipulation of energy supplies during the Cold War.

Britain’s ability to work closely with Germany on the future of EU energy policy has been constrained over the last couple of years by another factor. Britain was a strong supporter of the European Commission’s proposal to drive the liberalization of the EU’s energy markets by ‘unbundling’ the control of French, German and certain other EU national energy champions over both power generation and distribution. Not surprisingly, this initiative met strong German and French resistance. Britain appears to have recently eased back its endorsement of the Commission’s position, possibly in return for French and German support over British concerns about the EU’s working-time directive.

- Britain is now in a position to set aside its singular emphasis on promoting greater short-term competition between key energy players in Europe through ownership ‘unbundling’ in favour of a policy that emphasizes the building of cross-border European energy infrastructure (electricity networks, linked grids, etc.). Britain and Germany should make this the principal route towards a more integrated European energy market within which competition could then flourish.

The priority here should be to ensure that national grids are not bundled with national energy champions. In contrast, national champions and other large-scale energy companies operating in a Europe-wide energy market could still generate new levels of competition.

Expanding European energy choices

A further gap in the armoury of the EU is in energy choices. These are explicitly excluded from its competence, even under the Lisbon Treaty. Yet this is an issue which cannot be ducked if the EU is to have a coherent long-term strategy for tackling climate change. At present, some member states, including Britain, have nuclear power as part of their energy mix. Others do not. The present approach by the European Commission is to seek to set robust targets for GHG emission cuts and let the member states decide how to meet them. But the targets themselves have to be agreed by the member states, and it is already clear that some are having difficulty in meeting even the current targets and may therefore be unwilling to accept the much tougher ones that will be necessary in future.

One of Britain's consistent contributions to the success of the EU has been in persuading its partners not to duck difficult issues, however intractable they may be. This is another such challenge.

A 'European Energy Agency'

A central question for the future will be to know how best to create the processes and coordination mechanisms to drive forward this ambitious agenda for the EU's energy policy. Clearly, the European Commission has the legal responsibility to propose legislation to promote the kind of EU-wide energy policies we have recommended and for policing the energy market itself. And it would be for the Commission to represent the interests of the EU in international negotiations with energy suppliers should it acquire this mandate in the future (as we propose below).

- We believe, however, that there is a strong case for establishing also some form of European Energy Agency, to which member states would second national staff and experts. This would have a role in implementing the policies for completing the practical and technical infrastructure upon which new EU energy policies would need to be built.

For example, the agency could plan the physical interconnections of grids, the setting of transmission standards and the financing of storage projects. It could help promote

cooperation across the EU on research and development into renewable technologies, where economies of scale may make the difference between success and failure of new initiatives. It could also offer options for Europe-wide licensing, extending beyond the EU, for example of new nuclear facilities, including mutual recognition of safety standards. Finally, the agency could be a reinforcing mechanism for the International Energy Agency by serving as the European forum for thinking through possible national European responses to strategic energy shocks and helping plan well-coordinated emergency response procedures.

The establishment of functional EU agencies has a mixed record so far, so the objectives and design of a European Energy Agency would require careful planning. Given the evolving nature of the European energy market, for example, there would be a strong case for inviting key energy transit and supply countries, such as Norway, Ukraine and Turkey, to have an observer status in the agency. As noted above, it could also have a remit that captures the interconnections between evolving energy policies and responses to climate change, including in the design of EU carbon markets.

Developing a capability for EU external energy representation

The more the EU is able to develop a single physical market for energy, the greater the potential for Britain and other EU member states to agree on coordinating their external representation on important energy questions. The fact that the EU will be facing in Gazprom a state-owned monopoly under tight political control demands a better-coordinated European external energy position.

- Currently, there is no common external energy policy of the kind that exists in trade matters. Urgent consideration should be given to the scope for a common external energy policy in which the terms on which Russia and other energy providers secured access to EU markets would be negotiated centrally by the European Commission on a mandate from the member states, treating the EU market as a single whole. We recognize that this would entail a

treaty change, but believe that it could bring and, just as important, be seen to bring, real advantages to most constituencies within the EU.

At present, France, Italy and Germany are leading the way in promoting national policies, regardless of the wider European interest and the longer-term costs in terms of Russian power over EU markets. Britain is traditionally the country most resistant to the use of the Community method in EU matters. But, just as Margaret Thatcher accepted treaty change to achieve the Single Market, so Britain now needs to think radically on energy. If Britain concluded that use of the EU's common negotiating strength was the best way of promoting and safeguarding the national interests of the member states, it would be far harder for others to resist the political logic.

The Russian government is already concerned that the EU's capacity to set a common price for carbon might affect member states' approach to energy usage. Russia can be expected to do all it can to block the emergence of a more coordinated European external voice on energy policy, just as it has sought to block the inclusion of the transportation and other requirements of the Energy Charter in the proposed new Russia–EU Partnership and Cooperation Agreement.

In the near term, the British government can perhaps use the EU debate over setting a common EU approach to the foreign ownership of strategic economic assets (brought about as a result of the rapid inflow of funds from sovereign wealth investment vehicles) to devise a common corporate governance model within the EU for the control

of energy assets. Thus, even if Gazprom were to acquire controlling interests in EU energy companies, these would still be governed by EU rules on their operations and their financial transparency, meaning that the European Commission could fine Gazprom if it were to engage in any illegal market behaviour.

A radically different approach

Britain must prepare for a fresh approach to its energy security over the next few decades. It now finds itself in the same position as most of its EU counterparts – increasingly dependent on energy imports, especially gas, and with its options for adjustment severely constrained not only by cost, but also by its environmental commitments to combat climate change,

In this context, Britain can play a leading role, much as it did in the establishment of the Single Market over twenty years ago, in building a more integrated European energy market. Primarily, at the outset, it can do this by breaking down the barriers to the cross-border electricity grid and gas pipeline interconnections which will create a far more robust energy market for all EU member states, including Britain.

Once a more integrated European energy market is in place, Britain and other EU member states can decide on how best to negotiate the terms of their access to global energy supplies. We believe that giving the capacity to negotiate such terms to an EU representative who is responsible to national EU governments would be the best long-term outcome.

Conclusions and summary of recommendations

The results of the French and Dutch referenda in May and June 2005 and the Irish vote in June 2008 reflect a growing frustration with EU governments' obsession with the question of what Europe is rather than what Europe does. British scepticism about European integration is increasingly shared across Europe. The danger is that the British will now indulge in a protracted period of popular self-congratulation and governmental caution about all things European. The correct approach, in our opinion, is to use this moment to be creative and proactive, both for reasons of British self-interest and to help produce approaches to the EU's problems that will suit all members of the EU, Britain included.

In this report, we have laid out a British agenda for Europe that looks to the future. It highlights five key areas where Britain's interests will be best served through close cooperation with its EU partners and through EU institutions. It also offers an agenda for Europe, suggesting where the EU collec-

tively should place its efforts over the coming years. Most of our proposals are not dependent upon further treaty change, although some proposals might benefit from adaptations contained in the Lisbon Treaty and one – the transfer of negotiating authority on energy imports to the European Commission – would entail an important treaty change. They are all dependent, however, upon governments demonstrating the will to act together and to make the compromises necessary to be successful.

“The correct approach is to use this moment to be creative and proactive, both for reasons of British self-interest and to help produce approaches to the EU's problems that will suit all members of the EU”

Our agenda is built upon five conclusions and the recommendations that we think should be derived from them.

As these show, current institutional uncertainty about the future of the EU is obscuring what an important time this is for Britain to think strategically about its agenda for Europe. The British government should not delay in testing out initiatives that will enable it to get the most out of its membership of the Union while strengthening the EU's collective capacity to deal with the challenges of the coming decades.

1

Britain and its EU partners have entered a new international context that is still in formation. A more defensive United States coexists warily with increasingly confident new world powers. Growing transnational risks such as climate change and migration could tip fragile states into collapse. We draw the following key conclusions and related recommendations from this international context:

- The US–UK relationship will remain special in the areas of intelligence, military and nuclear cooperation, but is unlikely to recover the political closeness of much of the Cold War and immediate post-Cold War periods. In coming years, therefore, British governments can no longer assume that their international policies should be coordinated first in Washington and then sold to their European partners.

- Britain's ability to confront the key international challenges of the next decade – combating climate change, dealing with Iran or the Arab-Israeli conflict, fighting international terrorism or engaging with China, for example – will depend upon the existence of strategic EU policies.
- The EU will need more effective means of taking and implementing decisions in the fields of foreign and security policy than is currently the case.

Recommendations

- 1** Keeping an intergovernmental approach at the heart of EU foreign and security policy is both practical and a reflection of political realism.
- 2** In an enlarged EU, core groups of member states should be encouraged to take a leadership role on behalf of and in close coordination with the EU for those external issues that are of greatest importance to them.
- 3** Britain should support the creation, as soon as possible, of some version of the European External Action Service (EEAS), one of the innovations of the Lisbon Treaty, in order better to coordinate national and collective EU capabilities for external action. As a first step, the European Commission's existing delegations around the world could start to include staff from the Council Secretariat and national diplomats as well. These diplomats and Council staff could report to both the European Commission and to the High Representative for the Common Foreign and Security Policy.
- 4** Britain should resume its leading role in overcoming the divide between NATO and ESDP which affects their ability to operate together effectively around the world. Helping establish an EU headquarters which combines the EU's military and non-military assets, for example, should be a British as well as a French and EU priority in this context.

Examples of common areas for EU action:

- 5** One of Britain's top external EU policy priorities must be to make advances towards a 'global deal' to combat climate change in Copenhagen in 2009.
- 6** Higher levels of ambition and earlier commitments to decarbonization in the US are needed. China and India will depend heavily on EU leadership and action, not rhetoric. For example, the EU should play the lead role in ensuring that a fund is established with adequate resources to support the financing, development and deployment of new low-carbon and energy-saving technologies in less developed countries. Britain's influence on this agenda will be undercut if it continues to fail to meet its own national targets for cutting CO₂ emissions.

- 7 Britain should complement the growing EU–China strategic dialogue with a broader dialogue among EU members and with relevant countries on the dynamics of East Asian security.
- 8 The instruments of economic leverage alone will be insufficient to overcome the deep-rooted confrontation between Palestinians and Israelis. Britain and other EU countries need to start thinking now what they could bring to the table in terms of security guarantees for both sides in the context of a negotiated solution that involves the pull-back of Israeli security forces from the West Bank.
- 9 If there were an American or Israeli strike against Iran tomorrow, the EU would have as disunited a response as it did to Iraq. Scenario planning is urgently needed so that EU governments can prepare a coherent response in different potential circumstances.
- 10 Britain should help build a realistic EU strategy towards Russia that plays up constructive areas of bilateral economic integration, but that is more critical of and takes steps to counter Russia's use of its economic and military muscle to interfere in the internal affairs of its sovereign neighbours.
- 11 New avenues are needed for transatlantic debate, coordination and action on each of these topics. Ideally, this would entail a new transatlantic EU–US forum involving the relevant officials operating under the aegis of a ministerial council which would meet up to four times a year.

2

Our second conclusion is that EU members will enhance their future economic prosperity and security if they spread their evolving system of governance to other European countries which share European values and aspirations and which are prepared to sign up to the binding rules that comprise EU law. While we recognize the growing popular and political scepticism towards the EU enlargement process, we draw the following related conclusions and recommendations about future EU enlargement:

- It is neither necessary nor possible today to define the ultimate physical boundaries of the European Union. It is possible, however, to be clear about the mid- to long-term membership horizon for the EU.
- Although Russia is both a European and an Asian country, its geopolitical objectives as well as its political and economic trajectory mean that it is moving away from rather than towards a potential membership perspective.
- The countries of North Africa and the eastern rim of the Mediterranean cannot be classified as European countries, and will not become EU members for the foreseeable future. Given the vital importance for the EU that these countries develop successfully, the EU must create forms of partnership with them that extend beyond the current Barcelona Process and the country-specific European Neighbourhood Policy (ENP) Action Plans. France's proposed Mediterranean Union offers important new opportunities in this context.

Recommendations

- 1** A region as volatile as the western Balkans requires the full focus of the EU so as to help all of those states with a membership perspective complete the membership process.
- 2** The remaining countries of eastern Europe (Ukraine, Belarus and Moldova) should have an EU membership perspective. There is a compelling case for developing as soon as possible a formal pathway that could lead to enlargement negotiations with Ukraine, especially given Russia's growing assertiveness in its 'near abroad'.
- 3** Given the Caucasus' European linkages, the EU should consider developing a membership perspective with Georgia and other countries of the Caucasus, provided they demonstrate a full commitment to democratic norms, an open economy and the ability to take on the EU's legal structure.
- 4** The EU must stay true to its commitment to carry out negotiations with Turkey whose objective is full EU membership, provided Turkey accepts and meets the necessary entry criteria.
- 5** In order for Britain to have a chance of convincing other EU countries of the value of further EU enlargement, it must be more than just a champion of the strategy. It must be open to supporting adjustment assistance to EU countries and regions that bear the brunt of migrant labour and push for stricter measures to ensure that new entrants abide by the commitments that they make during their entry negotiations.

3

Our third conclusion is that Britain can enhance its domestic security significantly by working more closely with EU member states and institutions in the area of justice and home affairs (JHA).

- International terrorist groups such as Al-Qaeda have deliberately spread their operations across the EU since the late 1990s. Confronting a terror plot aimed at London but planned and coordinated in Stockholm, Frankfurt and Calais requires Europe-wide structures and procedures to coordinate judicial, police and counter-terrorism operations.
- Organized crime also operates on a Europe-wide basis, and illegal migrants, once inside the EU, can move relatively easily from country to country.
- Britain's island mentality disregards the increasingly mobile nature of contemporary threats. British security could have much to gain from deeper British involvement in specific, targeted EU initiatives, such as the Schengen Information System.

Recommendations

- 1** The British government must determine how much confidence it has in the ability of EU partners to enforce their judicial, policing, border control and visa measures. Otherwise, integrating fully into an EU-wide area of justice, freedom and security may not be in Britain's national interest.
- 2** The British government needs to resolve its approach to managing identity information about British citizens if Britain is to join the Schengen Area and its intelligence-sharing system at some point in the future.
- 3** In the meantime, Britain needs to work with its EU partners in specific areas of policy to improve their collective domestic security. In the area of criminal law, for example, it would greatly assist British and other EU countries' police forces to agree a definition of a particular crime that is common to all EU member states.
- 4** The British government should commission annual, independent audits of the performance of EU measures in the JHA area and of the gains and costs to British security of the British opt-in/opt-out arrangements. The findings of these audits should be reported to parliament and debated.
- 5** Parliament – or the British people directly – can then judge whether improvements in national security from closer cooperation with the EU should prevail over issues of British sovereignty and civil liberties.

4

Our fourth conclusion is that British and European economic growth will continue to benefit in an increasingly competitive global market from further EU market opening and deregulation. Britain should play a leading role in this process.

- Most countries in the EU are adapting to this more competitive environment, partly thanks to the disciplines of a single currency, and partly through national reforms encouraged by the 'Lisbon' process.
- The British economy, however, has entered not only a credit-driven squeeze but also a more structural down-turn relative to its EU counterparts.
- Acting collectively, Britain and other EU countries have the best chance to establish the rules of economic governance and market access within an increasingly competitive international environment.

Recommendations

- 1** Britain needs to argue the case for a more open European market with renewed vigour, given the rising calls for economic protectionism within and outside the EU.
- 2** Further opening up the EU markets for the provision of services, from professional services to utilities and financial services, should be a British priority, given the importance of this sector for future European growth and also for Britain's own competitive strengths.
- 3** Britain should resist the passing of EU laws that would restrict the ability of other countries to invest in EU countries on the grounds of national security, unless such legislation is transparent and is very narrowly circumscribed.
- 4** Britain should continue to guard against, and oppose where necessary, those EU-wide initiatives that are designed primarily to protect the national economic bargains, budgetary priorities and social contracts of other EU member states. For example, it does not make sense to try to set common EU rates of corporate tax. The strength of the EU will come from the interaction of its different systems of microeconomic governance that are each exposed to the pressures and constraints of national democratic politics and global economic competition.
- 5** Britain should approach the EU debate on social policy by emphasizing individual empowerment and improved opportunities for finding new employment (enabling workers to carry personal pensions across the EU, for example). The criterion should be whether new EU social proposals would be essential for the Single Market to operate fairly without discrimination, not the pursuit of harmonisation for its own sake.
- 6** Britain should continue to encourage an open and free market approach to the international economic relations of the European Union. This should include campaigning to resuscitate the WTO Doha Round, recalling that Britain is a firm supporter of the aims articulated in the Millennium Development Goals. Britain should also put its political muscle behind the April 2007 Framework for Advancing Transatlantic Economic Integration between the United States of America and the European Union to lower regulatory barriers to EU–US trade and investment.
- 7** Britain should reaffirm the policy set by Margaret Thatcher that the rebate should last only so long as the underlying problems that gave rise to it remain unresolved. The principle should be that countries of like prosperity should pay roughly the same proportion of gross national income into the EU budget in net terms.
- 8** The British government should insist that a greater proportion of the budget must be applied to a twenty-first-century agenda for the EU, specifically, increasing EU-wide research and development spending, including initiatives to combat climate change, and larger amounts for external action.

A further conclusion is that the risks and benefits of Britain joining the euro are changing. On the one hand, Eurozone economies still need to show greater convergence if the long-term risks to British economic competitiveness from joining the single currency are to be mitigated.

On the other hand, there are two new risks to remaining outside the euro. First, the pound may become increasingly vulnerable to volatility induced by competition between the world's two major currencies, the euro and the dollar, with possible knock-on effects for Britain's macroeconomic stability. This could be compounded by a return to big British current account deficits as revenues from North Sea oil and gas decline. Second, as the membership of the Eurozone continues to expand, there will be deeper economic consultation and coordination among Eurozone governments. Britain might find that remaining outside the Eurozone brings new repercussions, including possibly in the area of financial market regulation.

Recommendations

- 9** Britain should not give up the pound simply to avoid 'losing influence' in Europe, even if the Eurozone contains new forms of political-economic coordination.
- 10** We support the current government's position that membership in 'a successful single currency' could be of benefit to Britain. We also agree that the decision on whether or not Britain should adopt the euro in the future should not be a matter of principle. We are concerned, however, that, in these times of currency and economic turmoil, the question has become all but invisible. We recommend that the British government now keep the decision under regular review.
- 11** At the same time, British ministers should engage the British public in a mature discussion of the risks and opportunities that this decision could entail. Under future national or global economic conditions, the government may need to appeal to the pragmatic self-interest of the British electorate over giving up the pound.

5

Our fifth conclusion is that Britain should push for the development of the sort of EU-wide energy market which would benefit its own economy, that of its EU counterparts and their collective commitments to combating climate change, for the following reasons:

- British supplies of oil and gas from the North Sea are now rapidly depleting. The cost of gas to many new gas-fired power plants has been rising.
- The option of building new coal-fired plants (unless accompanied by full CCS) would run counter to Britain's EU and Kyoto commitments to cut greenhouse gas emissions. And simply sustaining current levels of nuclear energy will require significant new investment in this sector over the coming decade.

- Even the most optimistic scenarios show that renewable energy sources will deliver only about 11% of the UK's electricity supplies by 2015, and at considerable cost.
- Increased imports of gas will fill Britain's marginal increased energy needs and the bulk of this gas will have to come from Russia – and, specifically, from its monopoly supplier, Gazprom.

Recommendations

- 1 Britain should push for a more coordinated European energy strategy in order to be in a position to better handle Russia's dominant position within European energy markets.
- 2 The most important step in this regard is to create a more physically integrated EU energy market which would have the potential to lessen EU member states' vulnerability to supply disruptions. Interlinked EU energy markets could also deliver significant efficiency gains, principally through greater interconnectivity of national electricity and gas grids and through increased use of gas storage.
- 3 There is a strong case for establishing some form of European Energy Agency, which would help implement the policies for completing the practical and technical infrastructure upon which new EU energy policies would need to be built. The agency would not take on the European Commission's responsibility for proposing legislation for, or policing, the energy market itself. However, it could fulfil the following functions:
 - Serve as a central repository for sharing information and monitoring the status of the EU's collective energy needs, shortages and planned investments, including the physical interconnections of grids, the setting of transmission standards, and the financing of storage projects.
 - Help coordinate cooperation across the EU on research and development into renewable technologies.
 - Offer options for Europe-wide licensing of new nuclear facilities, including mutual recognition of safety standards.
 - Serve as a reinforcing mechanism for the International Energy Agency by thinking through possible national European responses to strategic energy shocks and helping plan well-coordinated emergency response procedures.
- 4 The more the EU is able to develop a single *physical* market for energy, the greater the potential for Britain and other EU member states to agree on coordinating their external representation on important energy questions.
- 5 Urgent consideration should be given to the idea of developing a common external energy policy in which the terms on which Russia and other energy providers secured access to EU markets would be negotiated centrally by the European Commission on a mandate from the member states and treating the EU market as a single whole.

Appendix

List of participants in the workshop 'Europe after Fifty: Visions and Expectations', Chatham House, 22 and 23 June 2007

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Charles Grant, Director, Centre for European Reform, UK

Sasha Havlicek, Executive Director, Weidenfeld Institute for Strategic Dialogue, UK

Pål Jonson, Member of the Board, Swedish Atlantic Council, Sweden

James Kariuki, Head of Policy Planning, FCO, UK

William Keegan, Senior Economics Commentator, *The Observer*, UK

Kai-Olaf Lang, Senior Researcher, Stiftung Wissenschaft und Politik, Germany

Christian Lequesne, Research Director, CERI/FNSP, France and LSE – Sciences Po Alliance Professor, France

Karine Lisbonne-de Vergeron, Associate Researcher, Chatham House, UK

Nick Mabey, Chief Executive, E3G, UK

Dame Judith Mayhew, formerly Clifford Chance and City Adviser to the Lord Mayor and former Provost of King's College, Cambridge, UK

Professor Anand Menon, Director of the European Research Institute, University of Birmingham, UK

Richard Mills, Political Counsellor, US Embassy, UK

John Mitchell, Chatham House Associate Fellow, UK

Robin Niblett, Director, Chatham House, UK

Charles Powell, Deputy Director, Research and Analysis, El Real Instituto Elcano, Spain

Baroness Joyce Quin, House of Lords, former Minister of Europe and former MEP, UK

Gideon Rachman, Chief International Affairs Columnist, *The Financial Times*, UK

Peter Schmidt, Researcher, Stiftung Wissenschaft und Politik, Germany

Professor Pauline Schnapper, Professeur de Civilisation Britannique, Institut du Monde Anglophone, Paris III, France

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Nathalie Tocci, Senior Researcher, Istituto Affari Internazionali, Italy

Stephen Wall, Chair, Chatham House Commission on 'Europe after Fifty: Policy Implications for Britain', UK

Helen Wallace, former head of the Robert Schuman Centre at the European University Institute, Italy

Richard Whitman, Professor of Politics, University of Bath and Associate Fellow, Chatham House, UK

Notes

- 1 A 2007 Transatlantic Trends Survey by the German Marshall Fund of the United States estimated that only 50% of Britons view US global leadership as desirable – http://www.transatlantictrends.org/trends/doc/TT07KFR_FINAL.pdf.
- 2 For more information see Alex Vines and Roger Middleton, *Options for the EU to Support the African Peace and Security Architecture*, February 2008, Report for the European Parliament, available at <http://www.chathamhouse.org.uk/research/africa/papers/>.
- 3 For a more detailed discussion see Brian Crowe, *The European External Action Service: Roadmap for Success*, Chatham House Report, May 2008.
- 4 For a review of recent ESDP missions, see Jolyon Howorth, *Security and Defence Policy in the European Union*, London, Palgrave, 2007, chapter 7.
- 5 Commission of the European Communities, Brussels, 10 January 2007, COM(2007)2, Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions, Limiting Global Climate Change to 2 Degrees Celsius: The Way Ahead for 2020 and Beyond.
- 6 *World Energy Outlook*, International Energy Agency, Paris, November 2007.
- 7 David Miliband, British Foreign Secretary, laid out his ideas for an ambitious EU agenda to combat climate change in his speech to the Ralf Miliband Lecture Series, entitled 'Green Peace, Energy, Europe and the Global Order' at the London School of Economics, 7 May 2008.
- 8 'Saving 20% by 2020: European Commission Unveils its Action Plan on Energy Efficiency', Brussels, 10 January 2007, Memo/07/6. For document, see note 5 above.
- 9 For more detail on the evolution of the EU-China 'economic and strategic relationship', see Charles Grant and Katinka Barysch, 'Can Europe and China Shape a New World Order?', Centre for European Reform, May 2008.
- 10 For EU assistance figures, see http://ec.europa.eu/europeaid/where/neighbourhood/country-cooperation/occupied_palestinian_territory/occupied-palestinian-territory_en.htm. In comparison, US aid to the Palestinians, including the Palestinian Authority, in 2006 totalled \$150 million. See <http://fpc.state.gov/documents/organization/60396.pdf>.
- 11 The Russo-British Chamber of Commerce estimates that Britain was the largest source of FDI into Russia in the first nine months of 2006. It invested \$6,311 million, which represents 17.9% of total investment into the country. See http://www.rbcc.com/businessinfo/trade_stat.html.
- 12 'EU 2020 – The View of the Europeans. Results of a representative survey in selected member states of the European Union', Bertelsmann Foundation, 20 September 2006.
- 13 See the Eurobarometer poll, September 2007 at http://ec.europa.eu/public_opinion/archives/eb/eb66/eb66_en.pdf.
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- 21 The Home Office estimates that there are 400 organized crime bosses in the UK, with a combined wealth of £440 million. And 2 per cent of Britain's GDP is estimated to come from organized crime. See <http://www.homeoffice.gov.uk/documents/cons-organised-crime-300704/>.
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- 23 This would mean that EU-wide laws and regulations on JHA issues would be arrived at on a basis of initiatives from the European Commission and decisions in the Council of Ministers by qualified majority voting and which are then subject to the jurisdiction of the European Court of Justice.
- 24 See the National Statistics report, February 2008, on UK earnings from FDI for 2006 at http://www.statistics.gov.uk/downloads/theme_economy/MA42006.pdf, p. 53.
- 25 See UNCTAD Investment Brief No. 1, 2008 <http://stats.unctad.org/fdi>.
- 26 See, for example, André Sapir, 'Globalisation and the Reform of European Social Models', Bruegel Policy Brief, November 2005, www.bruegel.org. The so-called 'flexicurity' model of some of the Nordic EU member states – which allows companies to fire workers with relative ease, but then provides them with high levels of unemployment support while incentivizing companies to hire new workers – is proving particularly appealing.
- 27 Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovenia and Spain.
- 28 *EU Monitor* 46, Deutsche Bank Research, 4 May 2007.
- 29 Richard Baldwin, *In or Out: Does It Matter? An Evidence-based Analysis of the Euro's Trade Effects*, CEPR, June 2006.
- 30 To some extent the perceived 'falling behind' reflected the differing approaches to macroeconomic policy, with the US Federal Reserve under Alan Greenspan pursuing a much more positive 'growth' strategy.
- 31 See <http://www.whitehouse.gov/news/releases/2007/04/20070430-2.html>.
- 32 'The benefits of liberalising product markets and reducing barriers to international trade and investment: the case of the US and the EU', available at: [http://www.oecd.org/olis/2005doc.nsf/linkto/ECO-WKP\(2005\)19](http://www.oecd.org/olis/2005doc.nsf/linkto/ECO-WKP(2005)19).
- 33 The swings between the dollar and the euro have been surprisingly large over the past few years: in October 2000, the euro's low point, it only took \$0.83 to buy one euro, but for much of 2008, more than \$1.50 would have been needed. As the dollar fell after 2002, the pound was pretty stable against the euro for an extended period that lasted until 2007, yet from the onset of the credit crisis in the autumn of 2007, the pound has fallen sharply, dropping from around 1.45 euros to the pound to today's rate of 1.25, suggesting that the pound is now more influenced again by the dollar.
- 34 *Meeting the Energy Challenge*, Department of Trade and Industry, May 2007.

- 35 See Paul Stevens, *The Coming Oil Crunch*, Chatham House Report, August 2008.
- 36 'UK Renewable Energy Strategy, Consultation', Department for Business, Enterprise and Regulatory Reform, June 2008.
- 37 'Gazprom signs fuel supply deal with Libya', *Financial Times*, 18 April 2008
- 38 European Commission, *A Renewable Energy Roadmap: Paving the Way towards a 20% Share of Renewables in the EU's Energy Mix by 2020*, Memo 07/13, Brussels, 10 January 2007.
- 39 European Commission, *European Energy and Transport Scenarios on Energy Efficiency and Renewables*, DG TREN, European Commission, 2006.
- 40 For more detail on this analysis of the European energy market, see Dieter Helm's paper for the EU Informal Summit, Hampton Court, London, 27 October 2005, 'European Energy Policy: Securing Supplies and Meeting the Challenge of Climate Change' at www.dieterhelm.co.uk/publications/European_Energy_Policy251005.pdf.
- 41 See Dieter Helm, 'Russian, Germany and European Energy Policy', 14 December 2006, article for Open Democracy at http://www.opendemocracy.net/globalization-institutions_government/energy_policy_4186.jsp. The pipeline is planned to come ashore in Greifswald, Mecklenburg-Vorpommern.



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