THE UNHAPPY STATE OF THE UNION

EUROPE NEEDS A NEW GRAND BARGAIN

LOUKAS TSOUKALIS

The crisis has fundamentally transformed Europe's economic and political landscape. The continent has been divided between creditors and debtors, and between euro countries and the rest. Divisions run deep within countries as well, as inequalities grow faster. Trust is low, the economics is flawed and the politics toxic. Economic recovery is modest at best; it is also fragile and uneven. Courting with deflation, with high unemployment and anti-systemic parties on the rise, and with precariously high levels of public and private debt, Europe seems to be facing the future on a wing and a prayer. What is to be done to arrest Europe's habit of dangerously muddling through the crisis?

This Policy Network pamphlet presents the case for a new grand bargain to rescue the European project from the perspective of an author who uniquely bridges the gap between academic analysis, policy and politics. It is published in partnership with major European thinktanks in France, Germany, Greece, Italy and Spain. Translated versions will be disseminated in all six languages.

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About the Author

Loukas Tsoukalis is professor of European integration at the University of Athens, visiting professor at King's College, London, and the College of Europe in Bruges. Previously, he taught for many years at the University of Oxford and the London School of Economics, also at Sciences Po in Paris, the European University Institute in Florence and Johns Hopkins University in Washington D.C. In his work that has been widely acclaimed, he has always tried to bridge the gap between academic analysis, policy and politics. Loukas Tsoukalis is also a former special adviser to the president of the European Commission, president of the Hellenic Foundation for European and Foreign Policy (ELIAMEP) and member of the board of Policy Network.

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Executive Summary

The crisis in Europe manifests itself in many different ways, with economies languishing, some indeed imploding, anti-systemic parties on the rise, a growing disconnect between politics and society, and support for European integration reaching an historical low. All this is coupled with growing fragmentation between and within countries.

Some of the problems go further back. With time, the European project became much bigger, more intrusive and less inclusive, while external competition intensified in a rapidly globalising world. The permissive consensus on which it had rested for several decades can no longer be taken for granted.

The creation of the euro was the most daring act of integration and the driving force behind it was politics rather than economics. It is now clear that Europeans had willed monetary union but not the means to make it viable in the long run. In that sense, the euro was a terrible mistake and we are now paying the price.

It was a faulty design, but it was also bad luck that the first real test came with the biggest international financial crisis since 1929. The 2007/8 crisis was the result of colossal failures of markets and institutions that were certainly not confined to Europe. Yet its impact also revealed the weakness of the Maastricht construction, as well as the fragility of inter-governmental and inter-country bonds. It also uncovered all kinds of problematic children in the European family and exposed the limitations of political power set against a borderless economy that sets the pace and often dictates the rules.

Yet, the worst has been avoided so far against the expectations of many euro-doubters. The demise of the euro would have had incalculable economic and political consequences within the currency union and beyond. Many ‘unthinkables’ have happened in order to prevent it. On the other hand, adjustment has proved more painful and lasted much

longer in the euro area than anywhere else. European political leaders have tried to buy time, showing a strong survival instinct whenever they reached the edge of the precipice, but precious little strategic vision. Who pays the bill in order to exit from the crisis? This remains the most difficult political question of all.

Europe has been divided between creditors and debtors, between euro countries and the rest. Divisions run deep within countries as well, as inequalities continue to grow. Trust has been low, the economics flawed and the politics toxic. Meanwhile, the austerity forced upon the debtor countries has had devastating effects on their economy, society and the political system. Admittedly, those countries had lived on borrowed time and money for too long.

Some people believe or hope that the worst is now over. Markets have been relatively calm for some time, while countries are beginning to emerge out of painful adjustment programmes and the first signs of economic recovery have appeared. This is the optimistic scenario. Others however, are less sanguine. They remind us that Europe is courting with deflation, while growth is likely to remain modest, fragile and uneven in the foreseeable future. The large numbers of unemployed will be unable to find jobs any time soon and political extremism is on the rise. Public debt is now much higher than it was at the beginning of the crisis and private debt also remains very high. Europe seems to be facing the future on a wing and a prayer.

Germany has emerged as the indispensable country and lender of last resort – and Chancellor Merkel as the undisputable leader of Europe in crisis. The power balance has shifted within Europe. Germany enjoys a structural advantage in a monetary union that operates as a modern version of the gold standard and little else. Historical experience, however, suggests that it may not be viable for much longer unless the European monetary union also acquires a fiscal base as well as a legitimate political base on which it can stand.

The centrifugal forces are strong both between and within countries. What still keeps Europe together is the political glue that has solidified through several decades of close cooperation and, even more important, the fear of the alternative. There is much unhappiness with the state of the Union today and integration has turned into a negative-sum game in the eyes of many Europeans. But still, the majority remain convinced that the costs of disintegration would be even higher. It is the equilibrium of terror in a sense, yet an equilibrium which is unstable and prone to accidents.

Europe needs a new grand bargain to break its Gordian knot. The initiative can only come from the strong, not from the weak. How much are the Germans willing or able to underwrite the European project? How much are the debtor countries (and others) willing or able to reform? And are the French willing or able to credibly reclaim their role as co-leaders? These are essential parts of the puzzle, although not sufficient. The new grand bargain will require a broad coalition of countries and the main political families in Europe to recognise the value of the European project and the need to give it new shape and form in a rapidly changing environment.

Supply-side economics and the goal of long-term fiscal consolidation need to be matched urgently with measures to boost demand and stimulate growth. Without credible answers to the questions of debt and bank recapitalisation, without a clear programme to strengthen the economic dimension of Economic and Monetary Union, the prospects for growth will be uncertain, if not grim, and the viability of the euro will degenerate further.

The European project needs to become more inclusive again, thus increasingly catering for the needs of those on the losing side of a long economic transformation that culminated in the big crisis of recent years. Europe's conservative agenda today cannot provide an adequate response. Unless it changes, anti-systemic parties and

protest movements will continue to have a field day, nationalism and populism as well. It would be extremely short-sighted to lump together all kinds of protest as populist, and simply dismiss them. Populism and growing Euroscepticism should serve instead as an alert for wounds that have been festering for years. It may turn into a red alert when the results of the European Parliament elections are announced in late May.

The euro has become a make or break issue for Europe. It has also become the centrepiece of the European project, and this is unlikely to change anytime soon. We must therefore draw the necessary conclusions. As it stands, euro governance is neither effective nor legitimate. It needs new policy instruments, stronger common institutions, more democratic accountability and an executive able to act with discretionary power. They will provide the balance against a set of constraining rules on national policies which are necessary as well. And all that leads to a new euro treaty that should be able to face the test of democracy in member countries, on the condition that no country has the right to stop others from going ahead and that each national parliament – and/or citizens when a referendum is called – is presented with a clear choice, namely in or out. Democratic legitimacy will have to be fought for; it is not a given.

Some European countries, notably the UK but also others, will not be willing or ready to take the political leap forward. There should be room for them under the bigger roof of the EU through a revision of the existing treaties. More flexibility and differentiation will be necessary in an EU of 28 and more.

If we continue with the muddling through, Europe will remain weak, internally divided and inward looking: an ageing and declining continent, increasingly irrelevant in a rapidly changing world and with a highly unstable and poor neighbourhood. The challenge is not just to save the common currency: it is to provide more effective management

of interdependence, tame markets, create the conditions for sustainable development and more cohesive societies, strengthen democracy and turn regional integration once again into a positive-sum game: a tall order admittedly, but also a challenge worth striving for. More integration where needed and more national or local responsibility wherever possible: this could be the motto for Europe. If we succeed, we would also have useful lessons to teach the rest of the world.

A. Introduction

The state we are in

Everybody talks about the crisis in Europe, a crisis that manifests itself in different ways. And now, some are beginning to see the light at the end of the tunnel, grasping with anticipation at the first signs of economic recovery. Others are, however, less sanguine: they fear that recovery looks modest and fragile at best, that it is uneven, and that big problems remain unresolved, reminding us that the crisis runs very deep. It is not just the economy, stupid.

Anti-systemic parties have been gathering strength in several countries riding on a wave of populism and nationalism; a growing disconnect has developed between politics and society. The European project that had earlier helped to transform the dark continent[1] into an area of peace, democracy, open borders with shared sovereignty and ever rising prosperity, has come under the biggest challenge since the very beginning of regional integration in the 1950s.

This is Europe's crisis in a nutshell, of course with a strong economic underpinning, yet experienced in different ways and degrees by Germans or Greeks, Dutch, Portuguese or Bulgarians, old or young, those with safe jobs or their less fortunate fellow citizens in the *precariat* class. And this is indeed another important dimension of the crisis, namely the growing divergence between and within countries that risks splitting Europe apart.

It has been the worst economic crisis since the end of the Second World War. The economies of the EU-28 as a whole will be lucky if they recover by 2015 or 2016 to match the standards of living they enjoyed in 2007: a lost decade which many fear will extend long into the future. Some economies on the periphery of Europe have lost large chunks of their national income during the crisis. One needs to go back to the years of the Great Depression in the 1930s to find anything similar. And unemployment has risen fast, reaching in some countries levels that would have been

unimaginable during peacetime. Youth unemployment is much higher: a wasted generation risks being the biggest collateral damage of the crisis.

Much of the output lost yesterday and today is unlikely to be regained tomorrow. Unemployed people become long-term unemployed, while some of the best brains and the most mobile leave those countries worst hit by the crisis and many will never come back: it is a vicious circle.

Those more familiar with political processes are just as concerned as their number crunching colleagues. Many talk about the crisis of democracy in societies where trust in institutions and politicians is rapidly on the way down and choices facing electorates are being squeezed. The extremes are growing, while alienation from the political system is more pronounced among the young who often choose to vote with their feet.

This is the age of uncertainty and precarious jobs for an increasing number of people in the developed world, not only in Europe, while some continue to enjoy the benefits from globalisation and a shrinking world. The two sides hardly understand each other, and this surely undermines social cohesion. Inequalities within countries are growing, while welfare systems are coming under greater pressure in times of austerity, in some countries of course much more than in others. This further aggravates the problem. We may be indeed witnessing the reversal of the process of social integration that went on for several decades after the Second World War.

Nationalism is rising, and so is populism. An increasing number of people look for scapegoats, preferably outside the national borders or to immigrants at home, and for easy solutions to the complex problems of today's world. European integration risks being one of the main victims: popular support has suffered a big decline in recent

years. There has also been a serious loss of trust between countries, extending all the way from governments to citizens, while ugly national stereotypes have resurfaced in public debate. Meanwhile, some of the fundamentals have changed, including the balance of power inside Europe and the ways of managing interdependence between its constituent parts.

While Europeans have been trying to deal with the crisis at home, they had to ask for help from outside. Asking for American help was something that Europeans had long been used to, mostly in the security field, but having the International Monetary Fund (IMF) as an arbiter and provider of record amounts of financial assistance for an essentially internal European problem was not something that most of them had been prepared for. Nor were indeed the others, especially in emerging economies, who have been asked to fork out substantial amounts through the IMF in order to save countries much richer than themselves. It certainly did not do much good for Europe's image abroad. Europe has not been at its best, to put it mildly. As for the Chinese leaders, they must have savoured those occasions when asked by Europeans to help save the euro. After all, they are the biggest creditor of all in the world and they have a long memory of humiliations suffered at the hands of Europeans in the past.

True, the worst case scenario has been avoided, so far at least: the worst case scenario, in the eyes of a majority of political leaders and citizens in Europe, being the breakup of the euro and the general process of disintegration likely to follow. But the price already paid is big and the rest of the bill is still to follow: it will not be small either. Europe is changing – many people think it is on the way down – and the crisis acts as catalyst.

Is it the end of an era, the end of a long success story that had marked the second half of the twentieth century continuing into the new one for a few years, a story of peace within and beyond borders, of democracy

spreading from the West to the South and then to the East, a story of constantly improving living standards? Only some time ago, most Europeans were convinced that it would continue to be more of the same and the most optimistic among them, including non-Europeans, went as far as predicting that Europe would lead in the 21st century,[2] united in its diversity as the official slogan goes.

After all, Europe had the model for other countries to follow. It had inclusive societies, advanced welfare systems and policies increasingly geared towards sustainable economic development. It had open borders and a long experience of sharing sovereignty that could offer lessons for the management of interdependence in a globalising world. And it also had new forms of soft power that were meant to replace, albeit gradually, the hard instruments of war in international relations. Europe as a model: it was indeed an attractive proposition for the old continent trying to reinvent itself in a world where it no longer called the shots.

The crisis seems to have shattered such hopes – or were they just illusions? All varieties of Eurosceptics and Europhobes, both within and outside Europe, rejoice. 'We had told you so. National sovereignty is the only solid foundation on which to build, and soft power is yet another example of post-modern illusions, together with multiculturalism and other such nonsense', so they repeat loudly for everybody to hear. And because most of them are close to the right end of the political spectrum, they also criticise unaffordable welfare systems that give the wrong incentives as regards work. So much for the European model or models: the Eurosceptics and Europhobes never believed in them, and they are now in the ascendancy in some places more than in others.

They can capitalise on the present state of malaise in crisis hit Europe and they can draw from the reservoir of discontent of European citizens, which had been already there before for a variety of reasons, be they immigration, growing inequalities or the feeling of disempowerment

in a world where so many of the decisions affecting peoples' lives are seen to be taken from a far off place, leaving them with little or no power or influence.

The problems are real, but the solutions that nationalists offer come from another age. They pretend national solutions are indeed possible in many policy areas, thus ignoring the reality of interdependence already reached in Europe and beyond, as well as the costs that cutting oneself off would entail. They build on intolerance of the 'other' and they refer to a mythical nation-state that has little or no connection at all with the real world around them. And they refuse to recognise that in a multipolar world in which power is rapidly shifting from the West to the East, while size continues to matter a great deal, individual European countries, even the big ones, do not count for very much. Already today, there are no big European powers by international standards. It will be even truer tomorrow. Economics and demographics will take care of it.

It is in many ways an existential crisis for Europe and the European project, testing the limits of the joint management of interdependence in times of growing economic divergence and nationalism, also testing the limits of European solidarity in times when societies are increasingly turning into collections of individuals and solidarity is coming under much stress even within national borders. And that is not all. In times of rapid globalisation, external competitiveness often comes at the price of more inequality internally: this is a very difficult equation to solve politically.

There are difficult trade-offs between efficiency, stability, equity and sustainability within and between countries, opposing pressures from global markets and democracy at home. They lurk in the background of debates relating to the management of the euro and the single market. And in today's world, more often than not, disagreements boil down to the way pain not gain is to be distributed within and between countries. We no longer live in the age of plenty.

Europe has been high on the political agenda in recent years, not always for good reasons. Europe has been the object of discontent and generalised unhappiness in difficult times. And it has often served a scapegoat, more than in the past. Luckily, this is not where the story ends. During the crisis, a growing number of Europeans have come to realise in concrete terms that, despite the differences, we are all in it together. They are those who go beyond the mere exchange of insults and stereotypes. This is one of the few positive developments in an otherwise gloomy picture.

The European Parliament elections of May 2014 are an opportunity for the European debate to advance further, thus helping to highlight the main issues facing Europe today and the choices associated with them. This is, after all, one of the main functions of elections in a democracy, is it not? However, previous elections to the European Parliament have been essentially a collection of second-order national elections, with the abstention rate rising as the powers of the European Parliament grew: an awkward contradiction for those militating for a stronger European Parliament as a means of dealing with Europe's democratic deficit. It better be different this time round, because the stakes are really high, indeed higher than ever before. And it is up to all of us to make it different.

Those who believe that Europe matters need to take a more active stance than in the past. They need to relay the point that there are common interests and values, much less so loyalties, binding together the citizens of Manchester and Tallinn as well as the citizens of Paris, Hanover, Madrid and Sparta. They need to underline that common interests mean common problems that require common European solutions. When rabid nationalists and all kinds of demagogues try to occupy the centre stage and threaten to undo Europe's remarkable transformation during the last sixty years or so, taking advantage of legitimate popular discontent in times of crisis, the rest cannot afford to stay silent, or just remain on the defensive.

But it no longer helps to take refuge in the wooden language of Euro-speak that hardly anybody listens to, except for those well paid to do so, or pretend that all is well in the best of possible worlds. And it will not be good enough either arguing, as many economists and all kinds of 'global thinkers' often do, that political reality needs to adjust to economic necessity.

True, economic reality has become increasingly European and global especially during the last two decades or so, while political reality remains stubbornly national and local. But it takes a bold or rather naïve person to believe in the primacy of economics over politics – and politics is about people. Political legitimacy and people's loyalties are needed to underpin decisions and policies in a democracy; they cannot be created by fiat. This is a basic lesson learned the hard way throughout European integration, and it remains one of the key issues today.

Regional and global economic integration, itself the product of political decisions and technological developments, creates winners and losers. It no longer helps to pretend otherwise, because the evidence is overwhelming and people feel the effects in their everyday life. Nowadays, the politics of distribution is coming back again. There are choices to be made. Democracy cannot function without choices. Therefore, instead of wondering when politics will at last adjust to economic reality, we should try to ask a more relevant question, namely what kind of politics and what kind of policies might help to reconcile economic and political reality. Not any kind of Europe, in other words.

This paper is intended as a small contribution to the European debate about the current crisis and ways out of it. It will attempt to draw key lessons from the experience so far, starting with a quick journey back in recent history since the roots of the crisis go deeper. It will concentrate on the euro crisis, because it remains at the centre of Europe's problems

today, but it will also take a look at the bigger picture, namely the shifting balance of power in Europe, issues of governance and democracy, as well as economic divergence, inequalities and the link with globalisation. It will then sketch some of the pre-conditions and rough outlines of a possible new grand bargain to help lift Europe out of the mess. Continuing on the same course will condemn Europe to internal division and decline.

The year 2014 will be a crucial year for Europe. Ahead of the European elections, there will be further debate with a focus on Europe, sprinkled with large doses of populism which is, perhaps, unavoidable when so many people feel that the world is changing rapidly around them, not usually for the better, and they have little or no influence over events shaping their life. The political map is becoming more polarised and the popular verdict in the European elections is expected to be harsh on the mainstream parties, from Christian Democrats and Conservatives to Liberals, Social Democrats, Labour and Greens, which have always provided the core of support for the European project. It may be less harsh, if in the meantime they succeed in articulating credible answers to real questions, they recognise past mistakes (it would be brave and rather refreshing), and get rid of worn *clichés*.

The European elections will pave the way for the new political leadership of European institutions, with a time horizon of five years, and for key decisions that will hopefully follow and mark a turning point in a long and deep crisis. We need to prepare for them while reminding those who will have the responsibility to take them that the old top-down approach will no longer be able to deliver the goods. European decision-making relies too much on deals being made in intergovernmental conclaves behind closed doors. There is a huge problem of legitimacy with the way in which our leaders run Europe.

B. Before the Crisis

Bigger, more intrusive and less inclusive

The transformation of Europe during the second half of the twentieth century was a truly remarkable success story, and regional integration was part and parcel of it. The continuous expansion in terms of both function and membership is surely the strongest sign of the success of the European Union (EU) in its different incarnations. What better evidence is needed of the perceived usefulness and dynamism of an organisation than the accrual of ever more responsibilities over a long period of years, coupled with a never ending list of aspiring members ready to submit themselves to difficult admission tests? From coal and steel to just about everything, although with very different degrees of integration or cooperation from one policy area to the other, and from six to twenty-eight members in sixty-odd years, it is no small achievement by any standards.

We now more readily admit that European integration started as an elitist conspiracy, yet a conspiracy with good intentions and pretty remarkable results.[3] European integration rested for many years on the wide, permissive consensus of its citizens, in turn dissected into different national stories – narratives, in modern parlance. And because popular support for it was largely a function of how much European integration was perceived as delivering the goods, it usually went up and down with economic performance. In other words, love for Europe seemed to go largely through the pockets of European citizens. It has never been a cause that could mobilise people and has remained all along a low priority for most Europeans.

At the individual level, the typical supporter of Europe and the integration project is educated and well off, in the political mainstream, middle-aged or older and willing to move. They are the people who have provided the core of support. They more or less realise what is at stake, while also being among the most dynamic elements of their society. As for the young, they have never been attracted by Europe's bureaucratic face, although the post-national narrative goes down more easily with them. They also take the achievements of integration for granted, simply because they have never known otherwise.

Three important factors gradually eroded the wide consensus on European integration before the crisis struck. One was the slowdown of economic growth after the end of the Golden Age in the mid-1970s. High growth always helps to wash down all kinds of problems, notably problems of distribution. The second was globalisation, the effects of which began to be felt more strongly two decades later. European integration became increasingly identified with globalisation: a process of growing liberalisation and external competition that puts a premium on domestic adjustment and inevitably leaves victims behind; a process that also formed part of the neo-liberal order that may have indeed contributed to higher growth overall but has also produced more inequalities within countries. The third was the continuous widening and deepening of European integration: more countries joined, diversity increased while decisions taken in Brussels began to reach the nooks and crannies of our societies.

As a result, the European project became much bigger, more intrusive and less inclusive internally, while external competition intensified in a rapidly globalising world. Not surprisingly, it also became less consensual. From something faraway and little understood, yet seen as part of a system that delivers the goods, which is the way Europe and its common institutions were perceived by many European citizens for a long time, it does not take very much to begin to be seen as something alien and increasingly threatening. 'After all, it is run by foreigners, is it not?', so diehard nationalists remind us on every possible occasion. The permissive consensus built over the years had weak foundations. It had certainly not produced citizens of Europe in large numbers, since loyalties remained as national and local as ever. The consequences took long to sink in, and they came in successive instalments.

The new century found Europe preparing for the next big transformation – and it was meant to be much bigger than ever before including the replacement of the founding treaties by a European constitution,

a huge new enlargement following the disintegration of the Soviet empire and the creation of a common currency. Political will was meant to massively transform the political and economic order on the continent. Yet, when it came to the test, the will was found wanting and the preparations poor. Ambition was hence lynched by reality.

On the road to the European constitution, we learned that the benign conspiracy of the Six in the early stages of integration was simply not repeatable with much bigger numbers, a very different political context and much higher stakes. The gap between maximalists and minimalists on the big issues debated in the European Convention that was mandated to prepare the constitution was simply too wide. And there was another gap revealed later on, namely between national politicians and citizens on things European. While parliamentary ratifications of the constitutional treaty (itself a typical European compromise) went through in most countries with comfortable majorities, the results of referendums were very different showing much unhappiness or unease among citizens and also large amounts of ignorance. This did not just happen in the lands of the usual suspects. It was the French and the Dutch who killed the constitutional treaty.

The permissive consensus could no longer be taken for granted, while referendums became increasingly part of the European integration process. The old question of more or less Europe was getting out of date. The relevant question now was about the kind of Europe we wanted to build, but we had no political mechanism as yet to address it. Instead of a constitution, we thus ended up with the Lisbon Treaty, an even more unreadable document than its predecessors – and with hardly anything to add in terms of the much needed legitimacy for European institutions.

Successive enlargements have indeed been the most successful foreign policy of the EU. But they have come with a price in terms of the internal cohesion of the Union. This is not usually much talked about for the

sake of political correctness. Diversity multiplies with enlargement, especially as the EU extends to the periphery. There are many more different interests to be accommodated, while implementation becomes harder when countries join with weak institutions and a more loose approach to the rule of law.

Numbers also make a big difference. European councils of different denominations with ten or even fifteen members still behaved like a group. With 28 now, European councils are more like a mini UN conference. The behaviour of participants has changed as a result: the old chemistry is gone and the bigger countries are ever more tempted to strike deals informally. This has contributed to more inter-governmentalism: it is a very different EU.

Another lesson learned the hard way is that the so-called process of Europeanisation has its limits. In many cases, they are uncomfortably narrow. The EU exports rules, it provides benchmarks, it also offers money to the less developed countries and regions; but still there is only so much that a weak centre can do to influence, not to mention control, what happens in different parts of this modern democratic empire. In other words, the EU surely makes a difference, but it is not and cannot be a modern incarnation of Saint Panteleimon (or Saint Pantaleon, in the Western vernacular), the all-merciful heeler of all kinds of disease – and of institutional failure, one might add. We now also know that the pressure Brussels can exert on candidate countries is much more powerful before as opposed to after a country has joined as a member and hence begins to occupy a seat in European councils.

This does not mean, of course, that enlargements should not have taken place, or that the last entrant should close the door behind her. *Pax Europaea* has real substance; it has made a big difference in the way Europeans conduct their affairs between and within countries. But as it extends to new territories, the capacity of the centre is weakened

as a result. It is a kind of trade-off that those who want to spread *Pax Europaea* to Turkey, the Caucasus and perhaps beyond, pretend not to see. The trade-off exists and choices have to be made, but Europe feels uncomfortable with such trade-offs. It prefers to ignore them, only to find them again later and usually in more acute form. True, the old members have tried to link each round of enlargement with institutional reform and the adoption of new common policies as a way of avoiding dilution: not with much success, it can be said with the benefit of hindsight.

Was the euro a terrible mistake?

The hardest lesson of all that Europe has had to learn was about its new common currency, the most daring act of integration since the very beginning. This lesson came later; it has been very expensive, and it is not over yet.

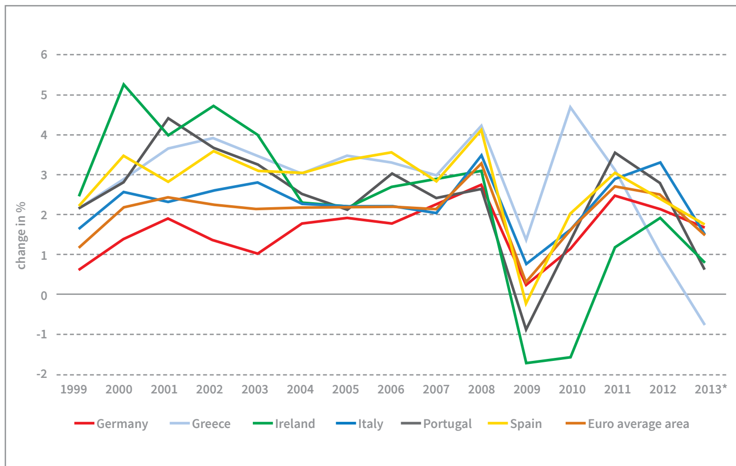
The creation of the euro was seen by many people as the crowning act of European integration: a European currency in the final stage of economic integration, strong in symbolism and with broad political ramifications. Political will was meant to turn an economically still heterogeneous group of national economies into a workable currency area. And geopolitics provided the driving force: it was the unification of Germany behind it all.

The compromise reached at Maastricht reflected the strong interest of France in creating a common currency as a means of tying a reunited Germany to a stronger European Union (the old Schuman logic applied once again), Germany's ability to set the terms of reference as a precondition for its participation, Britain's contentment with its opt-out, the prevalence of the new economic orthodoxy and the apparent lack of will (of most Europeans) to create a solid institutional and political base for the new currency. It looked like the Europeans were trying to repeat in the economy the miracle of the Immaculate Conception.

The Maastricht construction was politically weak and structurally unbalanced, but that was all that was feasible at the time. Back in 1997, Martin Feldstein,[4] chief economic adviser to President Reagan, had warned of the danger of serious political conflict within Europe and also between Europe and the United States as a result of a malfunctioning monetary union in which monetary policy would not be able to accommodate the divergent needs of its member countries.

Feldstein was one among many economists who expressed doubts at the time of creation about the desirability or feasibility of the economic and monetary union (EMU) project, although others did not usually go as far as he did with his dire political predictions. With the benefit of hindsight, we have to admit that Feldstein was fundamentally right, albeit with a dose of exaggeration. On the other hand, the many prophets of doom have been proved wrong (so far) repeatedly

Graph 1: Divergence in Inflation Rates (1999-2013)

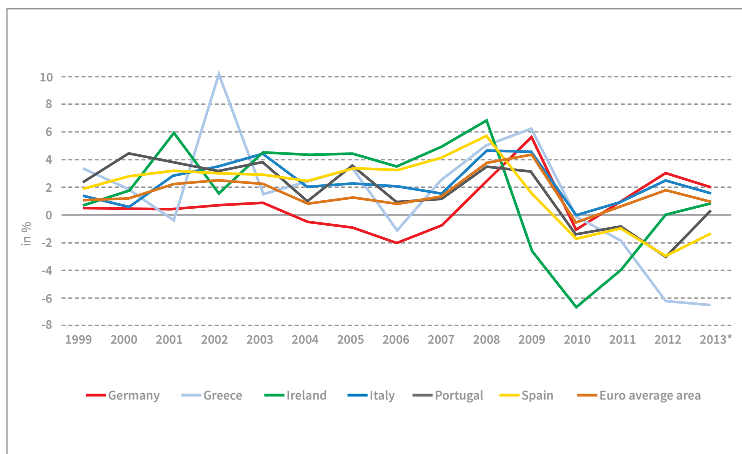


Source: AMECO. Harmonised Consumer Price Index. Provisional data for 2013.

predicting the breakup of the euro, almost invariably with a touch of *Schadenfreude*.

The honeymoon of the euro lasted for ten years, which is long given the differences in terms of economic structures and political institutions between partners, the fragile bonds linking them together and the weak institutional setup. The euro delivered price stability on average, rapid financial integration and an international currency that replaced the *Deutschemark* and slowly increased its share as an international trading and reserve currency, second only to the US dollar. It also eliminated internal exchange rate instability and risk that are hardly compatible with a truly internal market. But at the same time, divergence grew leading to ever bigger current account imbalances between member countries (Graphs 1, 2 and 3). These were financed by capital movements going in the opposite direction.

Graph 2: Divergence in Unit Labour Costs (1999-2013)

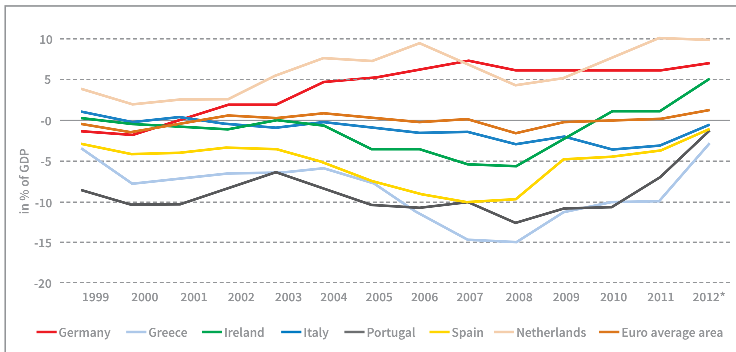


Source: AMECO. Ratio of compensation per employee to real GDP per person employed for total economy. Provisional data for 2013.

In the race for competitiveness whilst simultaneously being treated as the 'sick man of Europe', Germany kept wages and prices down to a level that even in the best of possible worlds it would have been extremely difficult for other countries to follow, while the countries of the periphery did not even try. Instead, they had a party with a consumption- and construction-led boom. The counterpart of their growing current account deficits was to be found, at least partly, in the surpluses of Germany (Graph 3) and those of other countries, such as the Netherlands, although their absolute size is small by comparison.

Deficits were financed mostly with borrowed money. The countries of the periphery borrowed credibility indirectly from the euro, and money directly from the countries with surpluses. Private debt increased fast as a percentage of GDP (Graph 4) in most countries of the euro area, but not in Germany; it also increased fast in the rest of the EU and beyond. The explanation can be found in low interest rates, ample liquidity and deregulated financial markets; the euro area was only part of a bigger picture. However, in the latter case, the elimination of the exchange risk worked as an additional factor.

Graph 3: Current Account Imbalances (1999-2012)

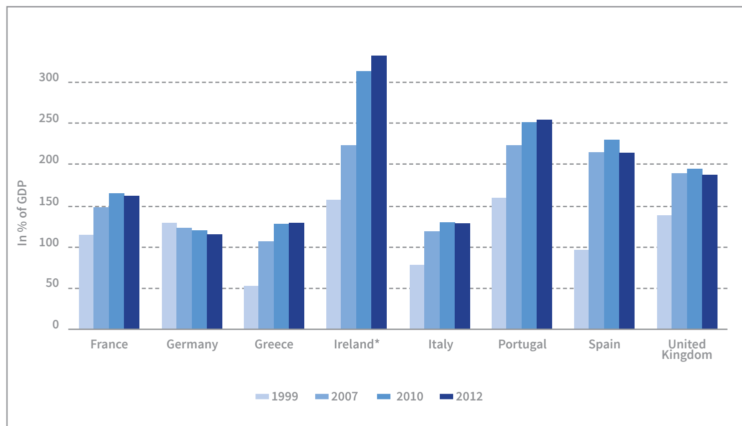


Source: Eurostat. Provisional data for 2012.

In many countries of the Western world, in the United States much more than anywhere in Europe, the fast increase of private debt compensated for stagnating or even falling real incomes of large sections of the population in times of low growth and rising inequalities, thus helping to sustain consumption levels that were clearly unsustainable in the long run. In other words, countries lived on borrowed time.[5]

And then the big crisis came, first as an international financial crisis in 2007-8 originating in the United States, which very quickly spread into the real economy and later acquired a strong European dimension. The European crisis is still with us today. What policymakers and analysts often conveniently forget, in search of simple explanations and culprits to blame, is that the crisis looks like a set of Russian dolls. You take one, open it and find a smaller one inside, and so on. The trouble is that those Russian dolls are one uglier than the other.

Graph 4: Private Debt as a percentage of GDP (1999, 2007, 2010 and 2012)



Source: Eurostat. The private sector debt is the stock of liabilities on a non-consolidated basis held by non-financial corporations, households and non-profit institutions serving households as a percentage of GDP. For Ireland, the data available start in 2001 and not in 1999.

The origin of the crisis was surely international: a big financial bubble that finally burst. It was the biggest since 1929. Colossal failures of markets and institutions were behind it. Financial deregulation had been justified by economic theories that spoke of efficient markets and rational actors with perfect information. Instead, there was greed, manipulation and moral hazard. There was also institutional and political failure. The bubble helped to keep consumption levels high and politicians in power, with politics often being hijacked by powerful lobbies. Some people made very large gains while the party went on, but it was mostly the rest who were later asked to pay the bill. Not surprisingly, trust in financial markets and politicians has suffered a great deal.

Inside the EU, and the euro area in particular, the crisis has taken a much bigger dimension because of the high levels of interdependence extending beyond national borders and a currency union with weak institutions and instruments: a currency without a state, as Tommaso Padoa-Schioppa[7] had so aptly put it some years back. The weakness of the Maastricht construction had as much to do with established ideas about the alleged efficiency of financial markets as with constraints imposed by political feasibility.

Coordination of economic policies proved inadequate in its conception and very poorly implemented. But even properly implemented, it might have prevented the Greek public debt crisis but not the Spanish and Irish bubbles that were privately generated. And when the tsunami struck, there was no crisis mechanism to deal with it because the architects of the Maastricht construction had been apparently afraid of moral hazard. It appears that European countries had willed monetary union but not the means to make it viable in the long run. In that sense, the euro was a terrible mistake and we are now paying the price.

Inside the euro doll, there are all kinds of national dolls. Some are in need of an urgent facelift: economic development models that

had long since reached their limits in times of rapid globalisation and intensifying international competition, as well as dysfunctional political systems. They lived on borrowed time when money was cheap and plenty. But when the crisis hit, their vulnerability was quickly exposed.

The first one was Greece, with a very large deficit in its budget and current account, in addition to a very sizable public debt, the result of many years of mismanagement, lack of reform and unsustainable living standards. When this happened, many European political leaders chose to believe that Greece was unique. Alas, other countries soon followed. It took Europe's political leaders some time to recognise, albeit reluctantly, that on top of the Greek crisis, there was a systemic crisis of the euro area, with the Irish, Spanish, Portuguese and Italians enduring their own crises, with similarities and differences between them. It was a painful recognition preceded by a period of denial.

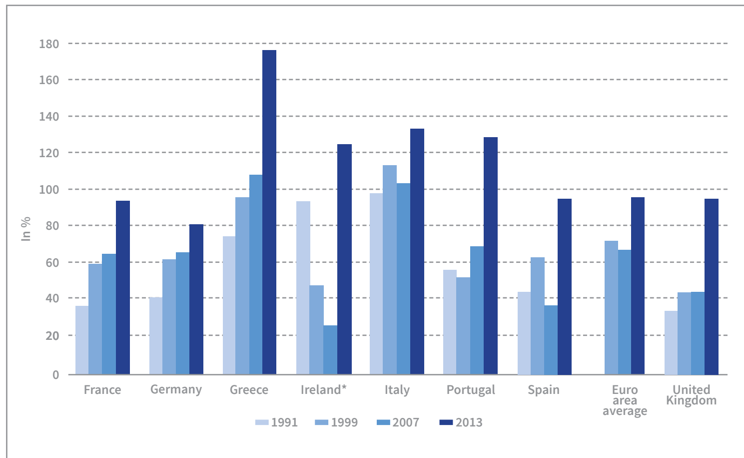
C. (Mis)managing the Crisis

Who pays the bill?

When the big bubble burst, many highly leveraged financial institutions in Europe (and also in the United States) were left with large amounts of toxic assets and on the verge of bankruptcy. Sovereigns soon followed, because they were forced to rescue their banks by incurring debts in markets that were fast descending into a state of panic, following many years of wild exuberance. Ireland and Spain are the most prominent examples of how a banking crisis turned into a crisis of sovereign debt (Graph 5).

It also worked the other way round, when heavily indebted states began to undermine the creditworthiness of their banks which were large holders of national debt. In an era of financial globalisation more than anything else, the umbilical cord between banks and states has never been cut off. Greece is an extreme example of how a bankrupt state can

Graph 5: Public Debt as a percentage of GDP (1991, 1999, 2007 and 2013)



Source: AMECO. General government gross debt as a percentage of GDP. Provisional data for 2013.

bankrupt its banks: Greek banks have been forced to write off all of their capital and more following the restructuring of Greek public debt. And then Greece had to borrow in order to recapitalise its banks: another example of a vicious circle.

Thus, the close embrace between banks and states turned into a death loop, when markets began to realise that insolvency was a very real threat. This realisation risked turning into a self-fulfilling prophecy particularly within the euro area, because member states no longer had control of the printing press and the European Central Bank (ECB) was not allowed to act as lender of last resort. This is precisely where the crucial difference lies between, say, Spain and the UK,[8] two countries with a serious banking crisis at home and comparable levels of spiralling public debt (Graph 5). The UK has benefitted during the crisis from significantly lower interest rates for its public borrowing compared to Spain, for the simple reason that it still had control of the key policy instruments – and markets knew it.

Members of the euro area no longer have the exchange rate as an instrument to deal with the cumulative divergence of wages and prices between member countries. They therefore had no choice but to resort to internal adjustment which is politically and socially much more difficult. And this in turn reinforced doubts about the sustainability of the common currency. Such doubts translated into large capital movements fleeing the embattled countries of the periphery for the safe havens of the financially stronger countries of the centre, completely reversing the direction they had followed in earlier years. Thus, the whole euro system came under attack, and it had precious few weapons with which to defend itself.

And then, all kinds of ‘unthinkables’ happened: erstwhile unthinkable decisions and policies that European institutions and national governments have been forced to take during the last four years in order to avoid an economic meltdown. The list is long. It includes national

‘bail-outs’ that dare not speak their name because they were supposed to be banned by the treaty of Maastricht, and the restructuring of Greek public debt that broke a big taboo about the sanctity of sovereign debt in Europe. The list also includes tough adjustment programmes imposed on debtor countries that have stretched the limits of national political systems, economies and societies, the direct involvement of the IMF in the euro area crisis with money and a strong say in the formulation and implementation of adjustment programmes, as well as new stringent forms of fiscal and economic policy coordination that will take the experience of shared sovereignty in Europe into new uncharted territory.

And there is more. Large amounts of money have been pumped into the system by the ECB, while its President, Mario Draghi, has declared that he ‘will do whatever it takes’ to save the euro, thus promising (or threatening) to act as lender of last resort by buying government bonds in secondary markets on the condition that the governments concerned submit themselves to an adjustment programme. Furthermore, a new European crisis mechanism (European Stability Mechanism) has been set up that was not supposed to be there because of the fear of moral hazard. The creation of a banking union is meant to be the next major step to follow.

It is a long and impressive list of ‘unthinkables’ that have succeeded in preventing the demise of the euro as well as uncontrolled bankruptcies of sovereigns and big financial institutions. But the price already paid is high, many problems remain unresolved and the crisis is not yet over. Overall it can be said that Europeans have shown a strong survival instinct that has once more surprised all forms of euro-doubters within Europe and beyond –but they have stumbled down this rocky path with precious little strategic vision.[9]

The explanation is surely not simple or one-dimensional. European political leaders have operated against a set of powerful constraints. Economic divergence has widened between countries and nationalism

has risen within: the combination makes the search for common solutions very difficult indeed, especially given the weakness of European institutions. There has also been a dramatic loss of trust between them, starting with 'Greek statistics', and a sore lack of a common language to interpret the crisis. And most important of all, the bill attached to a common exit strategy bears a number with more than just a few figures – and it may be getting bigger with time.

Who pays the bill? Who pays for bankrupt Irish banks: shareholders, creditors, domestic or foreign, the Irish or the European taxpayer, or more likely those who lose their jobs and then have to emigrate? And who pays for Greece's bankrupt state: creditors or taxpayers, within or outside the borders, rich or poor? The stakes are high and there are large sums of money involved, especially since the list of countries and banks in trouble has grown bigger with time. In the meantime, economics has been, perhaps inevitably, caught up with morality and the standards of morality have been set by the creditors. But are borrowers the only ones to blame when a bubble bursts?

Unprecedented amounts of money, indeed a multiple of annual EU budgets, have been committed in order to assist countries that had lost access to markets. The list includes Greece, Ireland, Portugal and Cyprus – also Spain in order to help it recapitalise its banks. The total amount of official assistance for those countries is more than half a trillion euros, and almost half of that amount is for Greece alone. Official lending has thus replaced private lending when the latter was no longer available. However, the total amounts spent for official assistance represent only a small part of what was spent by member countries of the EU during the early part of the crisis as state aid to banks in trouble: four and a half trillion euros, the equivalent of 37% of GDP of the EU as a whole, was spent between October 2008 and October 2011.[10]

Collective agony peaked when the crisis reached Italy: the size of the country and even more so the size of its public debt made Italy a country

too big to fail but also too big to save. And then, the ECB decided to step in to reassure the markets. Even larger amounts than those committed to assist national treasuries in trouble have been recycled via the euro system, comprising the ECB and national central banks of the euro area, again replacing private channels of the interbank market that had seized up.

Countries on the receiving end have had to consolidate their budgets, push wages down and reform under strict surveillance by their respective 'troika,' consisting of representatives of the European Commission, the ECB and the IMF, with the task of monitoring the implementation of national 'memorandums of understanding' and acting essentially as representatives of the creditors. A new set of stringent European rules and sanctions has also been introduced applying to the virtuous and sinners alike. Meanwhile, banks that had lent large amounts of money when the times were good, thus feeding the bubble, were hastily offloading those loans as much as they could under the protective umbrella offered by the euro area with the assistance of the IMF.[11]

We now know who has paid the bill so far. Private creditors, most notably banks, were protected with money and guarantees from European taxpayers, European institutions and the IMF. The only exception was the partial restructuring of Greek sovereign debt. Debtor countries borrowed large sums of money and were forced to go through a very painful internal adjustment, the cost of which was born mainly by the weaker and/or more vulnerable members of their societies. The debt accumulated will hang over the younger generations. Meanwhile, taxpayers in creditor countries have undertaken significant credit risks.

Buying time at high cost

Non-believers in extra-terrestrial economics knew all along that adjustment to a post-bubble and post-crisis world would be painful and most probably protracted, for some countries of course more than

for others depending on how bad the starting point was. Unfortunately, the actual adjustment has proved even more painful and much longer than anticipated – and this holds true for Europe as a whole.

Policy measures have been invariably late, always less than required, while implementation has been unduly long, leaving much to be desired. The succession of measures addressed to individual countries gradually developed into something that resembled a strategy – muddling through is the term frequently used to describe Europe's (mis)management of the crisis. Admittedly, a strategy is always much easier to conceive on paper than it is to implement particularly in the post-modern European policy setting. As we know, European decision-making is by its nature extremely slow and cumbersome, while financial markets are very fast, though following the instinct of the herd and hence not always wise.

Austerity and reform became the policy slogan of Europe in crisis, and the tone was set by creditor countries. No doubt, fiscal consolidation was and still is required in many European countries and further afield. Ageing populations, rapidly rising health costs, unsustainable pension systems and the large increase in sovereign debt resulting from bankrolling the banks after the bubble burst do not leave many governments with much of a choice in the medium- and long-term (Graph 5). The older generations have left their successors with a large bill to pay: this is a distorted version of inter-generational redistribution.

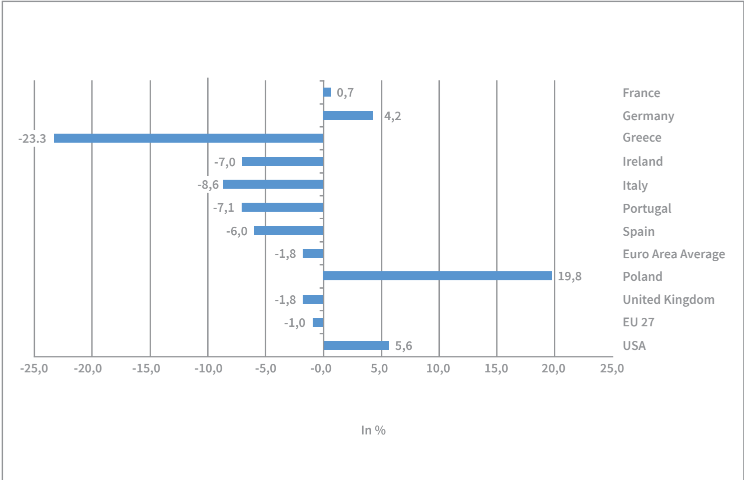
But if many countries resort to fiscal contraction simultaneously in times of panic when the private sector is also trying to reduce its debt exposure, the probability of ending up in a vicious circle of austerity and recession is very high. And then, the reduction of public (and private) debt as a percentage of GDP becomes, in part at least, a self-defeating exercise.

This is precisely what happened in the debtor countries where economies began to implode with fiscal contraction and under very tight monetary conditions created by the fragmentation of European financial markets

and the flight of capital from the periphery. The recession was both long and deep, and the negative repercussions spread to the rest of Europe. The IMF belatedly recognised that the speed of fiscal adjustment was excessive. The so-called 'fiscal multipliers' proved much bigger than anticipated. In fact, all macroeconomic predictions by official institutions have been widely off the mark, especially for Greece.[12]

Greece lost more than 23% of its GDP between 2007 and 2013. The corresponding figures for Italy, Ireland, Portugal and Spain range between 6% and 9% (Graph 6). The loss in terms of living standards was even higher in all countries. The unemployment rate reached 27% for Greece and Spain, and more than 17% for Portugal (Graph 7), while emigration has been gathering momentum. During the same period, real GDP fell by 2% for the euro area as a whole and unemployment rose by four and half percentage points, reaching above 12%.

Graph 6: The Impact of the Long Recession: Real GDP 2007-2013

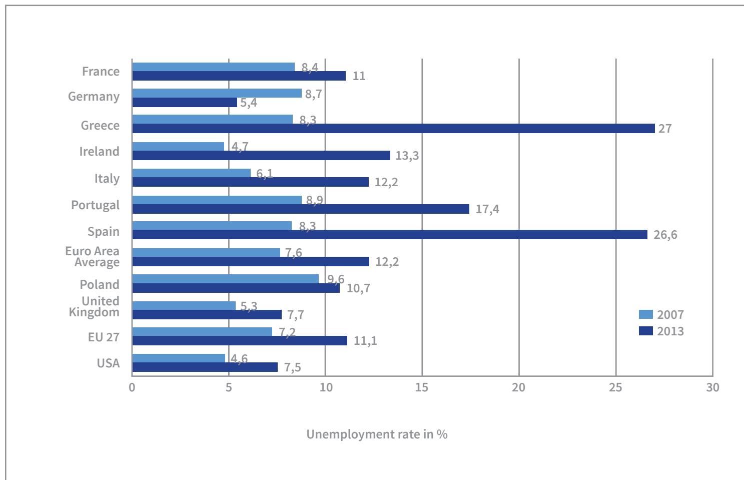


Source: AMECO Provisional data for 2013.

Germany stands out with a gain of 4% in real GDP during the same period and unemployment falling below 5.5% in 2013. As for France, it occupies an intermediate position between the relatively successful North and the sinking South: real GDP remained virtually unchanged between 2007 and 2013, while unemployment has been rising. It can, of course, only be a matter of speculation how much of the economic contraction in many countries could have been avoided under different policies, both national and European.

The emphasis on austerity stemmed from the official narrative that the crisis was mainly the result of fiscal profligacy.[13] This was indeed true for Greece, the country that started the ball rolling, but certainly not true for Ireland, Spain and other European countries. In fact, public debt as a percentage of GDP was lower in 2007 compared to 1999 for the euro area as a whole, and very much so in Ireland and Spain (Graph 5).

Graph 7: The Impact of the Long Recession: Unemployment Rates 2007-2013



Source: AMECO Provisional data for 2013.

The official narrative thus refused to recognise that it was, first and foremost, a banking crisis that Europe had to deal with. The contrast between American and European policy responses in the post-bubble adjustment is quite stark. The Americans have dealt with bank debt and restructuring relatively fast while delaying fiscal adjustment; the Europeans have done exactly the opposite. The consequences of delay in dealing with the banking problem are even greater given the much bigger role of banks in Europe. Judging from macroeconomic performance on the two sides of the Atlantic so far and assuming everything else being equal (admittedly, always a strong assumption), the winner is the United States by some distance (see Graphs 6 and 7).

The emphasis on rapid fiscal consolidation was gradually toned down from the summer of 2012 onwards in response to a dire economic situation. Yet, the fact remains that inside Europe the burden of adjustment has continued to fall on the deficit countries, while the surplus countries have taken the credit risk by providing directly or underwriting financial assistance to the former. The distribution of the burden of adjustment between deficit and surplus countries in a system of fixed exchange rates has always been a hot issue, first recognised by Keynes. When there are no jointly agreed rules, the will of those with stronger staying power will inevitably prevail: these are the surplus countries. Despite repeated efforts, mainly by the French, to ensure some symmetry between the two sides in successive stages of European monetary integration, the burden of adjustment has continued to fall almost exclusively on deficit countries. The economic effect is, of course, deflationary, which is however an old fashioned idea for many economists.

Be like the Germans: this is the underlying message in much of the policy recommendation offered in strong terms to other European countries. And there is surely some logic in it, since Germany has been a model of sound public finances, wage moderation and some aspects at least of structural reform; it is now reaping the benefits. Yet, there is a big flaw

with the argument that everybody should do like the Germans: it is the well-known fallacy of composition.

Germany has enjoyed an export-led growth largely taking advantage of its increased competitiveness during the first ten years of the euro, as it had done before for much of the period after the Second World War. By definition, not all countries can follow the German example and enjoy current account surpluses, because some at least have to provide the corresponding deficits. Is it politically realistic to expect that the euro area as a whole can rely on large current account surpluses for long, and will an appreciating euro allow this to happen? It is rather unlikely that the rest of the world, including the United States not to mention China, will step into accommodating positions.

Nobody can seriously dispute the need for a wide range of reforms in a rapidly changing economic environment. Many European countries have been in a state of denial for too long. But what kind of reforms do we have in mind, and under what conditions? Some countries need nothing less than a wide ranging reform to break the stranglehold of vested interests and to correct institutional failure. This takes time and cannot simply be imposed from outside. National elites need to take ownership of such reform, but the existing ones are usually part of the problem and not the solution. The frustration often shown by creditors may be understandable but hardly solves the problem. There is no simple solution, although a better mix of incentives and sanctions from Europe would help, as would a more favourable macroeconomic environment. And yet, the awkward question lurks in the background: how much room is there for laggards in the European currency union?

True, crisis may be indeed the mother of change, but in a shrinking economy structural reform is very difficult to carry through. The liberalisation of services and the opening of closed professions, reform of the labour market and the rationalisation of welfare systems are among the most frequently quoted reforms. They are bound to meet

strong resistance in the best of times. Resistance inevitably becomes much stronger in times of uncertainty and when the size of the pie is getting smaller.

It is no coincidence that German labour reforms under Chancellor Schröder were introduced when Germany was running large budget deficits, while subsidies to the citizens of former East Germany were as generous as ever. During the crisis, special emphasis has been placed on reform of labour markets, which are expected to act as the main shock absorber in a system where devaluations are no longer possible. But in times of rapidly rising unemployment and cuts in welfare expenditure, such reform is more likely to make things worse before they begin to get better. Try selling that message to voters.

It is indeed desirable to make it easier for unemployed people to find jobs. But if the end result is mainly the creation of low paid and highly precarious jobs, with a further widening of the income gap, it is a heavy (indeed unacceptable for some people) price to pay. Is there a trade-off between unemployment and inequality? Such trade-offs are not usually recognised by the advocates of reform, or they simply do not care. The experience of Germany suggests that labour reforms and a low minimum wage have indeed delivered the goods in terms of higher competitiveness and employment, but they have also contributed towards higher income inequality internally although from a relatively low starting base. The example of other countries with deregulated labour markets, such as the UK, is even stronger. The effects will be further pronounced in countries with weak welfare states.

While the process of adjustment continued, many European banks remained undercapitalised, bad loans kept on increasing during the recession, and the fragmentation of European financial markets persisted as long as the death loop between banks and states was not broken. Sure, there has been progress in that respect, since the ECB decided to

take more decisive action in the summer of 2012 and Europe's political leaders announced their intention to proceed with a banking union. For the first time, a comprehensive European strategy seemed to be in the offing to deal with the legacy of the crisis. It stopped, however, half way when complacency took over again as soon as financial markets gave politics a breathing space.

The promise (or threat) of Mario Draghi to 'do whatever it takes' has not yet been seriously tested by markets, but it has helped to buy time and restore relative calm, which is mainly what Europeans have been trying to do in different ways since the very beginning of the crisis. Meanwhile, negotiations on banking union have gathered momentum as the respective players try to reach agreement on the joint supervision of banks, the resolution regime and the harmonisation of deposit insurance schemes. This is not a simple matter: a European banking union would constitute the most important development in the European project since the creation of the euro.[14]

The long and difficult negotiations on banking union have revolved around the two obvious questions, namely who decides and who pays. What will be the division of labour between European and national regulators? Who will be entitled to decide to close down or restructure a bank deemed to be insolvent, and if so, under what conditions and who will bear the cost?

Europeans have traveled a long distance since the early 'bail-outs' in Ireland and elsewhere to the more recent Cypriot 'bail-in', which now seems to set a precedent for other cases to follow. European taxpayers should not pay for the mistakes of bankers: this is a good principle in order to avoid moral hazard. However, it has been applied selectively: compare Ireland with Cyprus. In the future, bank shareholders and creditors, even depositors, will be expected to bear the main burden when things go wrong. And there will also be a European fund to mutualise risk.

But all that will be in the future, with a long transitional period in between. During the intervening period, the death loop between weak banks and weak states will not be broken; hence, the legacy of the past will be carried forward. It may be understandable from the point of view of potential creditors. Why should the financially strong countries in the centre agree to underwrite weak banks (and states) in the periphery? Perhaps they would if they were convinced that the mutualisation of risk is the only credible alternative to write-offs. We are not there yet. But if so, the implication may be that the economies of the periphery risk languishing for a long period under the burden of debt, tied down with undercapitalised banks. This hardly makes for a happy marriage in the euro area.

For those who prefer to look at the bright side of the moon, Ireland shows the way. The Irish adjustment programme is now over and the 'troika' has left Dublin, hopefully, for good. In the early days of the New Year, Ireland successfully returned to the markets borrowing at a pre-crisis rate of interest; Portugal follows. In financial markets, again flush with cash, capital begins to return to the periphery of Europe and bond rates are falling. Does this signal the beginning of the end of the crisis, a crisis that brought with it so much economic pain?

This is the plan – and the hope. A reformed Europe, also fiscally more stable, will be able to return to healthy rates of growth. The markets will reward reform and fiscal consolidation, and investment will flow in. Are we not already witnessing the first signs of it? So remark the optimists backed by the new found euphoria in the markets.

But can it last? There is still a huge debt burden, private and public, hanging like an albatross from the neck of European states, banks, companies and private individuals (Graphs 4 and 5). Private debt remains very high, especially in Ireland but also in the Iberian countries and elsewhere, while public debt has skyrocketed as a result of bank rescue operations and declining incomes. For the euro area as a whole, public debt was close to 100% of GDP in 2013, near 180% for Greece and

more than 130% for Italy, also more than 120% for Portugal and Ireland: not a great achievement after four years of austerity and recession.[15]

History suggests that large debt overhangs, following long periods of bubble formation, are dealt with through a combination of growth, inflation and write-offs – or financial repression as the modern jargon goes.[16] Instead, courting with deflation, with negative growth until recently and prospects for modest, fragile and uneven growth for the foreseeable future, with large numbers of unemployed unlikely to find jobs any time soon and political extremism on the rise, with public debt much higher than in the beginning of the crisis and private debt still very high, Europe seems to be facing the future on a wing and a prayer.

Perhaps it is the best we can do under the circumstances: still buying time, slowly preparing our fellow citizens for the bitter truth, while preparing (and praying) for strong growth to come and, like the tide, lift all boats. It is a strategy of sorts; but all the while financial markets may be building yet another bubble.

Successful, but slow to lead

The word crisis does not exactly describe the experience of most Germans in recent years. After all, unemployment has been at historically low levels in that country, growth may be slow but it is generally positive, inflation is very low, public finances are under control and the current account surplus has remained as large as ever. For most Germans today, economic crisis is something terrible that happens to others; yet it is still uncomfortably close and in the headlines, thus forcing them to take big credit risks in order to save their partners, some of whom (they think) do not really deserve to be saved. And Germans are also fearful of losing out to tough and globally competitive emerging economic powers: the competitiveness argument is very strong in Berlin. Similar reactions can be found in other creditor countries, such as Austria and Finland. As for the Netherlands, the situation became more complicated when recession reached its borders.

The French had wanted a monetary union in order to prevent a strong, reunited Germany from dominating the European scene and they have ended up with German leadership or hegemony inside the euro area. However if President Mitterrand and his advisers had read the earlier history of European monetary integration more carefully, they might have thought differently at the time. After all, both the so-called 'snake in the tunnel' in the 1970s and its successor, the European Monetary System (EMS), had ended up as German-led exchange rate arrangements. Germany had acquired such a role for the first time since the end of the Second World War – and it had been precisely in the monetary field.[17]

In those earlier attempts at European monetary integration, German leadership had not been the product of any power game or a Machiavellian plot. Germany simply had the economic size, competitiveness and price stability that markets appreciated. As for the other countries participating in the regional exchange rate arrangements of the 'snake' and the EMS, they had been left with the option of either adjusting to German monetary policy or floating on their own. For those with relatively small and open economies, such as the Benelux countries very much dependent on the German economy, the choice had been limited to adjusting and little else. The biggest dilemma had been faced by France: economically very difficult to follow the German lead and adjust to German monetary policy priorities and politically costly to abandon a project France had fought hard to launch in the first place.

Later, the implicit assumption behind EMU was that other European countries would become like Germany, or perhaps that the Germans would meet the other European countries half way by adjusting their own priorities. Once again, neither happened. The institutional mechanism set up as part of the Maastricht construction to ensure economic convergence as a necessary pre-condition for a viable monetary union simply failed to deliver the goods. The Germans became more competitive (and internally more unequal), some countries followed their lead seeing themselves as part of an economic area with Germany as the

pivot, while others went partying in the mistaken belief that monetary union provided an easy way to prosperity – and German banks among others lent them the money, which also helped to buy German goods. It seemed like a good deal for all concerned until the crisis broke out.

The experience accumulated over several decades suggests that Germany enjoys a big structural advantage within a European system of fixed exchange rates. Its economic size and prowess, combined with a decades-long history of stability-minded policies and export-led growth, a corporatist tradition and largely consensual politics, have ensured its position as leader. In a European monetary union that operates as a modern version of the gold standard and little else, and with Germany at the centre of it, it is hardly surprising that several countries find it very difficult to cope having relinquished the right to devalue and the right to monetise their public debt.

The crisis has shifted the balance of power inside the euro area and the EU as a whole. Germany has emerged as the indispensable country and the lender of last resort – and Chancellor Merkel as the undisputed leader of Europe in crisis. Thus, much of the politics of managing the crisis has been played out in Berlin, often more so than in Brussels. The *Bundestag* has yielded more power over European decisions than the European Parliament during the crisis. And the whole of Europe has had to wait eagerly for the German constitutional court in Karlsruhe to pronounce on the boundaries of legality for European institutions and policy instruments set up to deal with the crisis. This is not the way to run Europe.

In its latest decision concerning the announcement by the ECB of its intention to purchase unlimited amounts of short-term government bonds, when deemed necessary, in order to prevent the fragmentation of the financial system of the euro area, the German constitutional court ruled by majority that the ECB would be exceeding its legal powers but still decided to refer the matter to the European Court of Justice.

It was not exactly clear who the victors were, although a new element of uncertainty was added.

Germany has tried and largely succeeded in keeping tight control of decisions and the way its money (and that of other creditors) is being used. Who pays the piper calls the tune, so goes an old English saying and there are similar ones in other European languages. The message is clear: the creditor countries give the money to save partners in distress, and they set the conditions to make sure they get their money back – or so they think. In the process, decision-making has become much more intergovernmental and several European Council and Eurogroup meetings have left a very bitter taste among participants; it will take much time and effort to wash it away. Common European institutions have been weakened with one notable exception, namely the ECB, which is a federal institution par excellence and the only one with the capacity to deal adequately and swiftly with the crisis.

On the other hand, the crisis has confirmed the worst fears of many Germans about an unnatural, as they saw it, cohabitation in a currency area with countries that did not share their own stability-oriented approach to economic policy. They felt cheated and angry[18] because they had saved and reformed in order to remain competitive and were now being asked to pay for the 'lazy Southerners.' Having paid dearly since East Germany joined the Federal Republic, many Germans were not at all eager to repeat the same experience on a much bigger scale in favour of other Europeans.

It would have helped, however, if they were also reminded of the large gains from export-led growth and a currency union that had allowed them a big competitive edge, as well as the gains from borrowing at negative real interest rates when Germany became a safe haven in times of crisis. And it might have also helped to complete the picture if they understood that saving Greece, Ireland and the other countries was an indirect way of saving German banks, although this would have hardly made the rescue of those countries any more popular at home.

For an ageing society of savers, with politicians who have been trained to speak of business and law rather than grand strategy and high politics, with a decentralised system and numerous internal checks and balances, with many economists who form a school of their own and with a strongly moralistic tone in its economic discourse, Germany's slow, often ambivalent and hesitant response to the euro area crisis is hardly surprising.[19] Nor is its reluctance to compromise on policy priorities, especially its strong stance on inflation.

There has been populism and scapegoating in Germany, as well as in other countries, which sometimes turned nasty. But in general, German political life has proved less vulnerable to organised expressions of populism and Europhobia than most of its European partners. Nor has Germany experienced the rise of extremist parties – opposition to the euro is not extremism. Sure, history has something to do with it, together with the existence of strong institutions that have passed the test of time, the consensual approach to European integration (and more) among the main political parties, and Chancellor Merkel's remarkable ability to manage and assuage the concerns and fears of German citizens while keeping the euro system and debtor countries alive – but only just. And, of course, nothing works better for political stability than economic success.

Germany is economically bigger and stronger than its partners – and it is more successful than most. It can therefore provide a model for other countries to follow, although always bearing in mind the limitations of trying to export successful models to other countries. On the other hand, leadership entails costs. How much is Germany willing to pay or risk as the price for leading Europe out of the crisis? It remains a big, open question. But Germany on its own is not big or strong enough to act as the white knight that saves the Euro-maiden in distress. The answer to the question therefore crucially depends on how its European partners behave. There has to be a *quid pro quo* – a joint effort, if you prefer.

Divided Europe

One of the key elements of the recent crisis in Europe has been the widening of economic divergences within the union, leading in turn to a divergence of perceptions and interests. The division between creditor and debtor countries has become stark inside Europe, and it has been accompanied by widespread recriminations and declining levels of political trust. AAAs and PIGS:[20] this is how the division has often been presented in the markets, with politics following their lead. It is difficult to find a precedent in the earlier history of European integration. The two extremes have been occupied by the Germans and the Greeks respectively: the popular caricature of the bad guy imposing his diktat on the suffering countries of the periphery against the image of the prodigal son calling for rescue.

What has also changed during the crisis is the role of France. The term *directoire* has a relatively long history referring to periods of Franco-German leadership in European integration. The creation of EMU was a typical product of it. And because the two countries usually started from different ends, the search for compromise between the two left enough room for other countries to squeeze in their own particular interests and concerns: it was the European version of compromise.

This time though, things have been different. France has found itself in an ambivalent position between North and South, a creditor still who nevertheless fears an eventual market onslaught and the negative verdict of rating agencies, unhappy with globalisation and unsure about the kind of reforms she may need to undertake: a French malaise in other words, hence also the growing distance between Germany and France, and the often deafening silence from Paris. If this continues for long, it will make for a very different Europe from the one we have known for decades: a Europe that many Germans will not like either.

Among the debtor countries, the crisis has had devastating effects on the economy, society and the political system. True, they had been

living before on borrowed time, with state- or private-created bubbles while reforms remained long overdue. When they finally lost access to international financial markets, or more precisely when the cost of borrowing became prohibitively expensive, they had to seek help from their euro partners and the IMF, who gave the money and set the conditions in order to restore the sustainability of public finances and economic competitiveness.

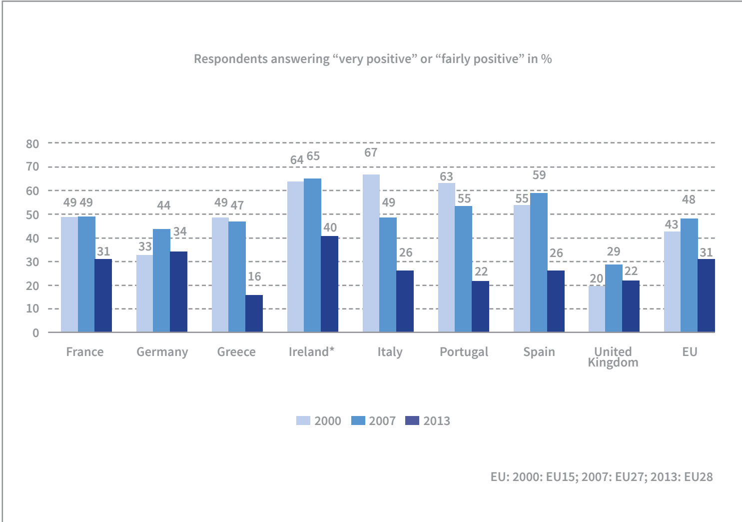
How much sovereignty and democracy can a bankrupt country afford? Not very much of either seems to be the answer, judging from the experience of countries with adjustment programmes in the euro area, although with variations from one country to another. National governments and parliaments have had to go through the humiliating experience of introducing wide ranging legislation en bloc in order to satisfy the demands of the 'troika'. Domestic reforms with significant distributional consequences have been seen as being imposed by foreigners – and populists at home naturally have had a field day. It does not help either that the distribution of gains before the crisis and the losses afterwards have been very unequal.

Humiliation and anger summarise the mood, especially in the European South. Trust in national politicians, as well as national institutions, has reached an all-time low, while support for European integration in the erstwhile strongly Europhile countries has sunk (Graph 8). If recession and high unemployment were to continue, the economic crisis would risk turning into a crisis of democracy. We may not be that far from it today in some countries. Gone are the days when the European South was seen as a model of economic dynamism and an example of how membership of the EU can help modernise countries and open them up to international competition.

Faced with the biggest challenge of adjustment in terms of both the economy and the state, with nothing less than a peaceful revolution required, Greece has been caught between the ineptitude of much of

its old ruling class and the populism of the opposition, the incoherence of European governance and the fundamentalism of the high priests of economic orthodoxy.[20] The results have been dramatic: economic implosion, social crisis and a political earthquake. Is Greece unique or extreme? Creditors have always wanted to believe it is the former, while many people especially in the southern periphery of Europe have feared that Greece may be leading the way – and it looked to them like the road to hell. A *sauve qui peut* attitude followed. Greece remains today the weakest link of the euro-chain: a tough test of endurance for a society very much unequal and on an edge, also a test of patience and solidarity for its partners.

Graph 8: Public Support for the EU (2000, 2007 and 2013)



Source: Eurobarometer. Percentage of respondents answering 'very positive' or 'fairly positive' to the question 'In general, does the European Union conjure up for you a very positive, fairly positive, neutral, fairly negative or very negative image?'

Italy is another country that has experienced a big rise in anti-systemic political forces, having tried to shore up the crisis by opting for a non-elected Prime Minister, Mario Monti, who was called upon at the peak of the crisis to stabilise the economy, reassure Italy's partners and calm the markets. Italy's problems stretch back over many years: economic stagnation and political deadlock with strong doses of corruption. Italy is closer to Greece than to Ireland, not only in geographical terms, although with a much stronger productive base. Many people in Brussels and other European capitals have been painfully aware of the danger that Italy might one day become the litmus test for the euro area and European integration in general. And the prospect sends shivers down the spine of both Eurocrats and lesser mortals.

It has not been nice and easy outside the euro area either, although the problems experienced by individual countries have not had the systemic effect created by the common currency. Among the worst affected have been the Baltic countries where economies imploded when the big bubble burst. International capital flows were very quickly reversed leaving behind them economic ruins. By the way, the same has happened repeatedly in other parts of the world following the liberalisation of capital movements. Even the IMF is now open to the idea that controls may indeed be desirable to deal with the high instability created by hot money; the old 'Washington consensus' is clearly no longer.

Those who believe in shock therapy in economic policy often use the example of Latvia,[22] the small Baltic country that implemented a very painful adjustment programme designed and monitored by the European Commission and the IMF. Latvia was not a member of the euro area at the time, but succeeded in keeping its currency pegged to the common currency and then joined the euro in January 2014 as the eighteenth member. The goal of macroeconomic stabilisation has therefore been achieved, and growth has returned; but, at what price? Latvia lost about a quarter of its GDP in the process, it dismantled most of its already lean

welfare state and also lost large numbers of its young and most mobile members of society who voted with their feet. Is Latvia a model for others to follow? Not many countries have such small and very open economies, nor do they have (luckily for them) the long and painful Soviet legacy that may indeed influence the citizens' endurance of pain.

The crisis has increased economic divergence within the group of transition economies in Central and Eastern Europe. Poland has had a successful economic transformation and its performance during the crisis stands out (Graph 7). The distance from other countries in the region has grown wider. Economic failure and political failure are closely linked together – and both usually produce anti-Europeanism. Despair seems to be the best word to describe how many Bulgarians feel today. As for Hungary, how much tolerance should Europe show towards the wayward behaviour of one of its members with respect to democratic norms and human rights?

Meanwhile, the UK exceptionalism has acquired renewed prominence. The British naturally feel relieved and justified in their earlier decision not to join the euro. With the benefit of hindsight, it was indeed a wise move. Less wise, however, was the decision to rely on the financial sector as the driving motor of the British economy, with British politicians, including those of the Labour party, acting for years as missionaries abroad for the deregulation of financial markets.

After the bursting of the big bubble, Britain faced one of the worst banking crises in Europe. But it responded fast and in a decisive manner. Unlike countries in the euro area, it had the policy instruments and the flexibility to do so – and made good use of them. It also prodded its partners to deal more effectively with the euro crisis, recognising that an eventual breakup of the euro could have big negative consequences for the UK economy, although it remained steadfast in its refusal to share any of the costs. Meanwhile, frustration grew as the euro crisis became the centre of European politics and policies.

As the crisis forced more integration on its euro partners, the UK steadily moved in the opposite direction. Euroscepticism gained new ground in a country where membership of the EU has always been seen mostly as a business affair or an arranged marriage, but certainly not an affair of the heart.[23] We now have to wait for the referendum that might take place in 2017 in order to find out whether the British people decide to stay in or move out of the EU. It will be preceded by a referendum in Scotland in September 2014, which will decide whether the UK remains united.

More than five years into the crisis that began with the bursting of a big international financial bubble, Europe is much weaker in economic and political terms. It is more inward-looking, more divided and less inclusive than it has been for a long time, yet it is also reformed in part. The European policy framework has become much tighter in terms of fiscal and economic policy in general. This is meant to prevent more crises in the future, although it will not leave much room for political choices in member countries.

The crisis has turned European integration into a negative-sum game in the eyes of many Europeans. Citizens in the creditor countries resent having to throw their savings into a bottomless pit, those in debtor countries see the EU as the enforcer of austerity that brings economic and social hardship on an unprecedented scale, while the others in the rest of Europe feel marginalised in a Union where the euro determines the core group, an unhappy group notwithstanding. The crisis is big and trust is low, the economics is flawed and the politics toxic. Hence, popular support for European integration has reached an unprecedented low (Graph 8).

Beyond the equilibrium of terror

Yet, Europe and the euro area in particular have held together despite the strengthening of centrifugal forces during the crisis. The fear of hanging separately, if they did not succeed in hanging together, has

kept everybody on board. The economic consequences of a breakup of the euro are extremely difficult, if not impossible, to predict. Trade and financial interdependence is very high and an eventual return to national currencies – how to do it would constitute in itself an awesome task – will entail big costs: substantial losses in trade and output, large numbers of bankruptcies and litigations across borders, not to mention the collateral damage of far-reaching political costs. Many people fear that a demise of the euro could lead to the unravelling of regional integration, thus bringing Europe back several decades.

Most Germans (and people in other creditor countries as well) are unhappy with the 'bail-outs' of partner countries. Although they are still making a profit out of them, they are morally indignant and also unsure they will get all their money back. They are also naturally worried about the additional credit risks associated with the large amounts of money recycled through the Eurosystem. However, they have not been prepared to pull the plug. This can be attributed to a combination of enlightened self-interest and unwillingness to take the blame for an economic or political disaster close to home.

More surprisingly perhaps, the majority of people on the European periphery who have crossed the economic desert in recent years and feel strongly against austerity policies imposed on them from outside – and let down by their national elites – still believe that leaving the euro would be much worse. They have not attempted, so far at least, to form a coalition, instead moving to out-compete each other in a race for brownie points from creditors and markets.

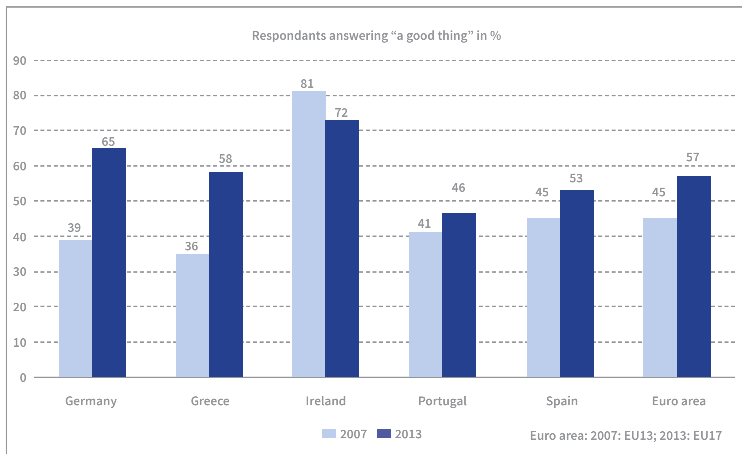
They fear the consequences of an uncontrolled bankruptcy and a general economic meltdown. They fear the unknown and they fear being left on their own in a highly uncertain and unstable environment. Thus, they still prefer to change things from inside the euro, or hope for better days to come, than walk outside. For the Greeks in particular, who have

suffered the most while also having the biggest problems to cope with, an eventual exit from the euro would constitute a return back to the Balkans – a frightening thought for most Greeks.

The high levels of public support for the euro are indeed remarkable, and they have risen since the outbreak of the crisis (Graph 9). However, the numbers do not communicate love for the euro, but fear of the alternative. It is also combined with very low levels of trust for national elites and institutions. According to Eurobarometer data, support for the euro in general is much higher than support for European integration, which has sunk.

It is the equilibrium of terror. Many Europeans are clearly unhappy with the present state of affairs and scared of the unthinkable consequences

Graph 9: Support for the Euro (2007 and 2013)



Source: Eurobarometer. Percentage of respondents answering 'a good thing' to the question 'Generally speaking, do you think having the euro is a good thing or a bad thing for your country?'

of a breakup, yet they are unable to agree, or even think, about ways of radically improving the terms of their joint arrangement. They need more integration to save the euro and the common project, but politically they do not feel ready for it and cannot agree on the contents. The creditors' understanding of more integration revolves around tight fiscal rules and structural reforms in the laggard countries, while the debtors' definition is wrapped-up in dreams of fiscal transfers and at least a partial mutualisation or write-off of debt. It is an unstable equilibrium and prone to accidents.

Such accidents could happen in the market or in politics, perhaps through a combination of both. Several accidents have already been avoided on the way. The Europeans have learned to live dangerously in recent years. Today, markets are moving in a favourable direction, again in a buoyant mood and in search of higher returns for large amounts of liquidity. However, this could be easily reversed.

Politics is the more likely candidate to suffer an accident. There are several political voices and parties calling for a breakup of the euro, or for the exit of individual countries. They are still in a minority everywhere. But if the unhappy state of the union is prolonged, this could lead to further fragmentation and growing dissent. Minorities could then turn into majorities in some places.

Although those most vocal against the euro are usually to be found in countries such as the Netherlands and France, to a lesser extent in Finland or Germany, the likelihood of an accident is much bigger in the European South. After all, this is where people have to put up with very high rates of unemployment and at best low growth. Creditors in the North may no longer need to dig around in their pockets to financially assist the South, except perhaps for Greece, which will require much smaller amounts than before. Historical experience also suggests that it is the weak countries that break off from currency unions not the strong ones.

If a major political challenge to the euro and/or the prevailing policy mix were to emerge in one of the smaller debtor countries, the creditors on the other side might be tempted to dismiss such a challenge and consider the possibility of a controlled exit from the euro area. Such a scenario was repeatedly discussed until more than a year and a half ago with respect to Greece, and it was finally rejected as too risky for the stability of the euro area as a whole. The fear of contagion was then in everybody's mind, but it surely also helped that the Greek government showed more readiness to proceed with fiscal consolidation and reform.

This issue may crop up again in the not too distant future and the outcome would be difficult to predict. Of course, if the accident were to happen in a bigger country it could mean the end of the euro. But remember, accidents do not usually happen by design. This is indeed the biggest risk today in a political and economic environment where so many things can go badly wrong or simply get out of control.

Both the 'snake' and the EMS had ended up as German-led arrangements with shrinking membership, following a big crisis that came at the culmination of a period of tension and incompatible policy objectives among the members. With the euro, we have had German leadership once again but steadily increasing membership, despite a much bigger crisis than anyone has experienced before. The rest of the story waits to be written. The situation we are in today is reminiscent of the old joke about the man who loses his way in the Irish countryside and asks a local for the way to Tipperary. And the reply he gets is that 'If I were you, I wouldn't start from here'.

This is precisely how it feels today. The crisis of the euro area is not yet over and the European project has come under sustained challenge. If only we had a choice, we would not start from here. But like it or not, this is where we are. We therefore have no other option but to take stock of an admittedly difficult situation, consider the options and try to agree on the direction ahead. The trouble, of course, is that there are many

different views, prejudices and interests – both between and within countries – little trust, and a weak sense of solidarity that is entangled with a creeping complacency that the worst may be over.

No doubt there is also a great deal of populism floating around in this heady mix; yet it is a populism that feeds on a succession of big political failures over many years, starting with the deregulation of financial markets and the incomplete construction of the euro, then carried further along with divergent and indeed incompatible national economic policies within the currency union, and bolstered once more by the political state of denial and muddled response that greeted the crisis. And populism of course feeds on a widespread feeling of injustice about the very unequal distribution of gains and losses before and after the big crisis.

Part of the problem lies with the one-way thinking that has prevailed in Europe, *la pensée unique* as the French call it, or the 'Golden Straightjacket' proudly announced by Tom Friedman[24] several years back as a corollary to globalisation and the alleged primacy of economics. But then the economics went wrong, and politics is now beginning to take revenge in its usual, rather messy fashion.

Several underlying trends predate the crisis: growing uncertainty in a rapidly changing environment characterised by technological revolution and big shifts in the tectonic plates of the global system; growing inequalities in societies where the private increasingly trumps the public; growing numbers of immigrants seen as a threat to domestic social standards and social cohesion; and growing debt as the economy cannot catch-up with popular expectations. Sure, the problems go much deeper and extend beyond the boundaries of the euro area and also Europe. But the recent crisis has put all those problems into much sharper focus, while also revealing the major weaknesses of the European construction and all kinds of national failures. In other words, borrowed time began to run out.

Is it indeed the end of an era? There are many reasons to believe that, although nobody can be sure when caught in an important turning point of history – and this is perhaps one we live through today. An Italian philosopher, Antonio Gramsci,[25] wrote about times in history when the old is dying and the new has not yet been born. In between, he warned us, it is the time of monsters.

Today in Europe, there are many signs of the old dying, but yet only fuzzy impressions and guesses of what the new might look like. Most politicians from mainstream parties still find it hard to think that this may be indeed the end of an era; they find it even harder to think out of the box. Meanwhile, the monsters have arrived: wild demagogues, rabid nationalists and all kinds of extremists. They will try to put on a show of force in the European Parliament elections in May, and they have a relatively easy job in criticising the existing order and tapping into popular discontent and anger. The latter is usually inversely related to age: many young Europeans are angry today, and they have good reasons to be so.

But how to persuade creditor countries that it is in their long-term interest to make concessions and take further risks in order to make the euro system sustainable, when trust remains in short supply and the prevailing attitude is one small step at a time? Furthermore, how to make the big step in European governance when public support for integration has reached a historical low?

It is the contemporary European version of the Gordian knot waiting for Alexander the Great to break it – and it is an almighty knot indeed. The sword to cut the knot should be a new grand bargain that helps to change the political and economic climate in Europe and restore confidence in a shared future. Such a grand bargain will require some of the 'vision thing' that former US George Bush Sr. and many of our political leaders today are apparently not very comfortable with. It should link a wide ranging programme of national reforms to a European project that is

once again able to deliver the goods. To put it differently, a successful European project needs to become part and parcel of national projects. Otherwise, it will not work.

The initiative should come from the strong, not from the weak. Leadership, like greatness in the words that Shakespeare put in Malvolio's mouth, has been thrust upon Germany in this crisis. In earlier phases of European monetary integration, Germany always refused to compromise in its policy priorities. It has done the same during the current crisis. But if it insists for much longer, the euro runs the risk of following the example of the 'snake' and the EMS when other countries were finally forced to walk out. This time though, the costs of exit would be much higher for all concerned – and creditors would simply not get their money back.

It is up to Germany to make good use of the leadership that has been thrust upon it by taking the initiative for a new European grand bargain.[26] How much are the Germans willing or able to underwrite the European project? How much are the debtor countries (and others) willing or able to reform? And are the French willing or able to credibly reclaim their role as co-leaders? These are essential parts of the puzzle; once they are there, the other pieces could gradually fall into place. Certainly, it would not be easy, although it has happened before in earlier stages of European integration.

Success will crucially depend on whether the European project becomes more inclusive, thus increasingly catering for the needs and concerns of those on the losing side of a long economic transformation that culminated in the big crisis of recent years. Who will challenge Europe's conservative agenda today? If the old established parties on the centre and left of the political spectrum do not do it quickly and effectively, others will fill the vacuum as they are already doing. Anti-systemic parties and movements will thus continue to have a field day, nationalism and populism as well. Centrifugal forces operate both between and within countries.

A new European grand bargain will require a *Große Koalition* (Grand Coalition) at the European level, indeed more inclusive than the coalition of Christian Democrats and Social Democrats running Germany today. In other words, what is needed is a broad coalition of the main political families in Europe recognising the value of the European project but also the need to give it new shape and form in a rapidly changing world. In what follows next, I shall attempt to sketch the rough outlines concentrating on four main themes, namely growth and cohesion, governance and democracy.

D. A New Grand Bargain

Growth and cohesion

Many people suspect that Europe may follow the experience of Japan in the 1990s and beyond: a long period of deflation and economic stagnation but with much higher rates of unemployment than Japan and nationalism flourishing across the continent. Others talk of the debt crisis of Latin America in the 1980s and the economic implosion that followed as a precedent for South Europe today. But most would agree that if European economies continue to crawl with high rates of unemployment persisting in large parts of the continent, the political and social consequences will be very difficult to cope with. Democracy may suffer, starting with the most vulnerable outposts, and European integration will also be one of the most likely victims. The signs are already there for all to see.

A reformed and financially strong Europe is a pre-condition for sustainable growth, so the preachers of economic virtue repeat again and again. This can only be achieved with long penance and strong economic medicine. They represent one side of the political and intellectual divide and they are the ones who have called the shots until now. Balance needs to be restored. Supply-side economics and the goal of long-term fiscal consolidation, which are indeed necessary, have to be matched with measures to boost the demand side of the economy and stimulate growth, today rather than tomorrow. This could be the first essential element of the new grand bargain.

The European Commission has adopted a more relaxed approach in the application of budgetary targets, but more will probably be needed depending on the robustness or otherwise of the economic recovery. One priority area should be more funds being made available for investment in infrastructure, education and training, research and innovation through the so-called Euro project bonds or any other means. Europe needs to invest in the future.

Another priority area should be to provide more liquidity in debtor countries. More than fiscal consolidation, the credit crunch is strangulating their economies. Without credit, those economies cannot

grow, and without growth they will not be able to pay back their debts. The European Investment Bank should play a more active role in providing funds for investment as long as private banks continue to operate under tight constraints.

Faced with the risk of deflation, since the average increase in consumer prices in the euro area has reached below one per cent, making internal adjustment in the debtor countries even more painful, the ECB will need to resort to more unconventional measures in order to expand its monetary base. Europe will need both growth and moderate inflation in order to be able to deal with its debt overhang. And this will in turn require a more symmetrical adjustment between deficit and surplus countries.

Several analysts have also referred to the role that the ECB can play in providing some extra breathing space for countries with a very large public debt through ordering a partial and implicit monetisation of this debt.[27] Of course, such measures remain highly controversial. They might be easier to accept if they were part of a broader package of measures in the debtor countries, including not only a wide ranging programme of reforms but also a wealth tax for the better off to help repay part of the outstanding debt. We need to think out of the box in order to be able to deal effectively with an extraordinary situation.

The contradiction of a currency without a state will need to be resolved, although this can only happen gradually. A monetary union cannot survive in the long run without some fiscal union and a legitimate political base on which to rest. A modest budget for the currency union with automatic stabilisers and transfers, preferably its own resources, financial incentives linked to national reforms, some joint issuing of debt, the mutualisation of risk in relation to the banking system; they are all necessary pre-conditions for a viable common currency. Of course, they will not all happen tomorrow. We know from experience that Europeans frequently apply in their common affairs the famous phrase of Saint

Augustine ‘God give me virtue, but not yet.’ However, such an attitude is dangerous in times of crisis. The first steps need to be taken soon and the road map agreed upon.

The restructuring and recapitalisation of many of Europe’s banks, following the bursting of the big bubble, has been unduly delayed. Politics and finance are intimately linked together and the crisis has revealed many skeletons in national cupboards. One suspects that there are more, especially in countries where the cupboards have not as yet been forced open. Bankruptcy sometimes has a cathartic effect, although the price paid can be very high. Banks with many bad loans and a weak capital base are an impediment to growth. Will Europe finally decide to face reality with the forthcoming stress tests of European banks? And if so, where will the new capital come from?

We have all been waiting for growth to come and like the tide help to lift the European economies out of the sand. But without credible answers to the questions of debt and bank recapitalisation, without a clear programme to strengthen the ‘E’ side of EMU, and not only through rules and constraints on national policies, the prospects for growth will be uncertain, if not grim, and the viability of the euro will not be secured.

On the other hand, it will not be realistic to talk about a European grand bargain while domestic social contracts are being torn apart. This is precisely what has been happening in countries worst affected by the crisis and to a lesser extent in other parts of Europe. The share of profits out of national income has been steadily rising at the expense of wages in most countries. Likewise, inequalities within countries, especially between the top and bottom ends of the income ladder, have grown further, creating more poor people in the process. Those inequalities have been only partially compensated by taxation and the national welfare state.[28] With cuts in welfare expenditure and the number of jobless people at a peak, the problem has become much worse during the crisis, especially in the badly hit countries of the periphery.

Cutting down on welfare and deregulating labour markets has been the mantra delivered from Brussels in recent years, and it has been fiercely applied to countries going through adjustment programmes. This is largely what is meant by reform. It has had important distributional consequences within those countries and it leaves a legacy that will shape the future. Dealing with the crisis as if it were mainly the result of overblown welfare systems and rigid labour markets instead of bankers running amok is really adding insult to injury.

There is, however, a much bigger issue relating to globalisation and technological change, the effects of which are being felt much more acutely by parties on the left of centre of the political spectrum. It has proved to be a very difficult, if not impossible, task to reconcile the interests of 'insiders' and 'outsiders' with respect to labour market reform; the interests of local workers – especially the low skilled – with the growing number of immigrants, and the goal of competitiveness with that of social cohesion. Even the more successful Scandinavian countries have serious problems in dealing with these tough conundrums.[29] The results can be seen in the shrinking vote share of several social democratic parties across Europe. Much of their erstwhile political constituency has already migrated to the extremes, more to the right than to the left.

High rates of unemployment are a time bomb, youth unemployment even more so. In South Europe, unemployment rates for those under 25 have skyrocketed while birth rates are declining further: ageing societies that hold little prospect for their young people. There is surely a problem with both the supply and the demand side of the economic equation in those countries. And there is a problem for Europe as a whole where the average rate of youth unemployment is double the average unemployment rate, which is also too high.

It has been officially recognised as such and the European Council decided to launch a programme on youth unemployment with a budget of €6 billion, which looks like peanuts given the size of the problem.

Europe often indulges in symbolic gestures when facing big problems, usually making hardly any tangible difference. The creation of a Globalisation Adjustment Fund some years back was another example of such symbolism that only widens the credibility deficit Europe already faces. Apparently, we do not learn.

The arguments usually employed against stronger European action in the social field refer to moral hazard and subsidiarity. However, strong conditionality could deal effectively with the problem of moral hazard: no free lunch in other words and no prizes for policy failure. Rules and regulations concerning labour markets as well as welfare provisions do and should remain predominantly the prerogative of member states. But if Europe is reduced to market integration and little else, especially in times when the number of losers within countries is on the rise, it has little hope of ever creating a legitimate political base on which EMU and more can rest.

Europe needs a social and caring dimension if it wants to once again win the hearts and minds of large sections of society in times when there is not all that much to go around. Given the circumstances the offer will have to be modest, but very well-targeted. European solidarity and rationalisation at the national level[30], within a broad framework of jointly agreed objectives and with European instruments in the role of facilitators, should provide the basis for a fruitful division of labour, and hence also become part of the overall bargain. A European unemployment insurance scheme complementary to national action should also be part of the overall bargain, as well as an integral part of the system of automatic stabilisers within the euro budget.

Tackling widespread tax evasion (or avoidance) of multinational companies and individuals who take advantage of the free movement of capital and tax competition among national authorities, as well as taxing financial transactions across borders, would strengthen the

revenue side of national and European budgets. This would help to provide more funds for social investment among other things and restore a feeling of justice in the sharing of burdens within our societies. Minimum tax rates may indeed be necessary to avoid a race to the bottom in the context of the single market.[31]

Free labour movement inside the EU and immigration in general are at the top of the political agenda in many countries. The numbers of European and third country immigrants have steadily risen, often going over the threshold of tolerance of local populations in times of economic crisis. 'The dykes are on the point of breaking',[32] as the Dutch would put it – and they have some experience in this respect. Parties on the extreme right in the Netherlands and elsewhere have drawn heavily on anti-immigrant feeling, especially among the poorer and lower skilled members of society who feel more directly threatened. In response, the language of mainstream parties has begun to incorporate more references to 'social dumping' and 'welfare tourism'. Meanwhile, countries on the other end of the migration circuit inside Europe, such as Bulgaria and Romania, are already suffering from an exodus of their best and brightest – and the most mobile.

It would be politically suicidal to allow demagogues and xenophobes a free play on this hot issue. It is true that an ageing Europe needs a steady flow of immigration from outside in order to keep the economy and welfare systems going. Europe also has a long and proud history of providing refuge to people whose basic human rights are downtrodden in neighbouring countries and beyond. But if flows turn into floods, there is risk of drowning.

Free movement of people across European borders is indeed one of the key elements of the common project. And it did work well in times of growth when the European convergence machine worked and the differences in standards of living were not that high between member countries; alas, no longer.

For free movement inside Europe to continue without causing much political and social upheaval, it will have to be coupled with a more effective protection of social standards in the receiving countries and policies to enable countries on the other end to create jobs and raise standards at home. Otherwise, Romania may be left with few medical doctors, for example. In conditions of slow or no growth and with the gap between the centre and the periphery in Europe further widening, the political and social pressures resulting from free labour movement will be very difficult to contain. And then, some of the fundamental freedoms of the European project will come increasingly under challenge.

Governance and democracy

Europe does not have a government, and it is unlikely to acquire one for some time at least in a form that most of us would recognise as such. Instead, it has a multitude of national governments accountable to their respective citizens and a complex system of common institutions, rules and norms to manage the extended web of interdependence that has developed over several decades. Commentators often refer to European governance, a term ambiguous enough to allow room for different interpretations, hence its growing use.

The creation of the common currency, now shared by 18 out of the 28 members of the Union, led European integration into totally new territory and most people (and countries) were apparently not prepared for the journey. Euro governance has changed a great deal during the crisis. There is now a much tighter and more comprehensive set of rules applying to national economic policy and budgetary policy in particular, with some discretionary power granted to the European Commission in the application of those rules, as well as an emergency mechanism set up on an intergovernmental basis and endowed with large amounts of money. When everything else fails, the euro system expects to rely on the ECB which will also be at the centre of a

banking union to be created in successive steps extended over a long transitional period; but on what kind of legitimacy?

The new rules have been essentially imposed by the creditor countries on a take-it-or-leave-it basis. They are meant to restrict national freedom of action and they are based on a particular and rather dogmatic approach to macroeconomic policy. On the other hand, there are hardly any compensating instruments at the European level. For the debtor countries, the way to Tipperary still looks long and arduous – and it has been decided by others. It is one thing to agree that budget deficits forever are not the way to achieve sustainable growth – and surely they are not – but it is a totally different thing to expect national democratic systems to fit into a tight policy straightjacket as the price to be paid in order to be able to keep the common currency.[33]

Some draw comparisons with the shock therapy adopted in transition economies after the fall of communism. They believe that the same should apply today in Southern European countries much in need of radical reform, including political and institutional reform in some countries more than in others. Yet, the two situations are very different. The fall of communism had left a political vacuum behind and its legacy was the best ally for a major transformation in the countries of Central and Eastern Europe in the 1990s. Hardly anybody dared to articulate at the time a credible alternative, and there was promise of a bright future especially for young people.[34] Try to compare this with the politics of austerity in the debtor countries of Southern Europe today, operating in an unfavourable European economic environment, with recession and high unemployment dragging on and on, populism on the rise and young people deprived of hope.

As it stands today, euro governance is neither effective nor legitimate, especially in the eyes of those expected to endure a long and painful

process of adjustment. It is also a system operating on the borders of legality as set by the European treaties. The promise of a better system (and a better world) looks distant and therefore lacks credibility. Fear of the alternative will not be enough to keep Europe together for long. For the common currency to survive, euro governance needs more effective policy instruments at the European level, stronger common institutions, and an executive that is democratically accountable and able to act with discretionary power. This will need to be balanced against a set of constraining rules on national policies which are necessary as well.

Should the new architecture for euro governance go through the difficult process of another treaty revision and the referendums that have become an indispensable part of it in many countries? Public opinion surveys today and previous experience would warn against. Not surprisingly, many national political leaders are keen to avoid another long drawn intergovernmental negotiation followed by parliamentary ratifications and referendums.

How to explain the complexities of European integration in times when mass politics turns into populism and simple messages? And how to defend Europe when people turn back to national and local identities as a protective shield against a rapidly changing, indeed often menacing, external environment? National political leaders will therefore be tempted to continue with the patchwork within the framework of the existing treaties and engage, when necessary, in legal acrobatics in order to defend decisions and policies that are not easily defensible from the existing treaty point of view.

It may seem pragmatic, but it is in fact terribly short-sighted. If such an attitude were to persist, Europe would continue trying to buy time, postponing difficult decisions, waiting perhaps for a miracle to happen, while the economic problems remain unresolved and political support further wanes. It would be a recipe for continued political fragmentation and economic stagnation.

The new governance of the euro will require a new euro treaty[35] open to any country of the EU interested in joining in the future. But only as long as no country has the right to stop others from going ahead and as long as each national parliament, and/or citizens when a referendum is called, are presented with a clear choice, namely in or out. Choices have a meaning only if they have consequences for those who make them. A qualified majority of countries and citizens should be required for the new treaty to come into force. The fiscal compact treaty has set a precedent in this respect. And if any country votes against, it stays out of the euro. It is admittedly a risk, but a risk worth taking. No right of veto also means a much lower possibility of everything being brought down to the lowest common denominator.

A new euro treaty should be based on a new and more inclusive grand bargain with institutions specific to the euro area and stronger provisions for democratic accountability. It should include a parliament for the countries sharing the common currency, either along the lines of the existing European Parliament but with more powers and fewer members or, perhaps preferably, bringing together directly elected MEPs with representatives from national parliaments of member countries. The latter would be a way of trying to bridge the existing gap between national parliaments and the European Parliament. This new parliament should provide the democratic control for a small European executive with clearly defined powers. Provisions should also be made for the representation of countries that have ratified the new treaty and are not yet ready to join the euro.

This new euro treaty should face with confidence the test of democracy. In fact, it would need to go through the democratic test in order to become legitimate. The permissive consensus on European integration is no longer there. It therefore needs to be rebuilt on the basis of a new contract. Political elites have lost the legitimacy and the margin of manoeuvre they had in the good old times. They need to argue their way through and explain why certain decisions and policies are no

longer effective at the national level and hence need to be taken jointly at the European level. And then, they can – and should of course - disagree between them about the contents: no politics without choices. Understandably, not everybody concerned feels up to the task.

The key question today is not so much about more or less Europe; it is rather about the kind of Europe we want to build. The euro area will need stronger European institutions and further transfers of powers in specific areas of policy; no point in pretending otherwise. But much more important will be the kind of policies to be adopted within a given institutional and policy framework.

The crisis has generated a lively European debate about what needs to be done, which is much more than a mere juxtaposition of national debates. ‘Hard-working Northerners’ are not just pitted against ‘lazy Southerners’. Alliances have been formed across national borders. And this increasingly European debate has been all-inclusive, from the populist variety sometimes turning nasty to well-informed exchanges among practitioners, and the more or less visionary speeches of a few political leaders who sometimes dare cross the threshold of the pedantic.

It remains to be seen whether different political parties and individual candidates will be able to take this debate much further during the campaign for the European Parliament elections in May. How much Europe will there be in those elections? And will citizens be presented with real choices regarding ways to exit from the crisis? If these elections prove to be yet another opportunity wasted by those who otherwise claim that the European project is crucial for democracy, prosperity and Europe’s standing in the world, there may not be many more left in the future. This is the time when European thinkers and policy experts may have an important role to play in helping to shape the agenda; they can look and communicate more easily across borders.

Of course, democratic legitimacy in Europe will continue for a long time to flow mainly through nation-states. But democracy at the European level will also need to be strengthened in different ways: here again, we have to think out of the box.[36] Is democracy possible without demos? Arguably, transnational democracy is very different; after all, we are not trying to reinvent the nation-state on a bigger scale. Europe is certainly far ahead of other regions of the world in this respect; it will need to experiment further.

A stronger economic and political union, as a necessary counterpart to monetary union, would probably be more easily acceptable in the periphery than in the centre of Europe. Citizens of countries that have been worst affected by the crisis still have more confidence in European institutions over their national counterparts. It may therefore not be that difficult to convince Italians, Greeks and Spaniards about the merits of a stronger Europe, for the simple reason they are convinced they need it. It will be more hard work up North: Germans, Dutch, and also the French, will need convincing. They will have to be persuaded that it is in their long-term interest to share their currency, and large parts of the sovereignty, with other Europeans in a much upgraded common project.

The euro has become a make or break issue for Europe. It has also become the centrepiece of the European project, and this is unlikely to change anytime soon. Assuming of course it survives, it will reinforce an already existing trend towards a two- or multi-tier Europe with growing differentiation inside it. The depth of integration already reached – together with the large number of heterogeneous members – arguably leaves no other option. It is therefore high time for Europeans to draw the necessary conclusions.[37]

Some European countries, notably the UK, will not be willing or ready to take the political leap forward, certainly not in the foreseeable future. There should be room in the EU for countries that choose to stay out

of the euro and the next stage of integration, temporarily or otherwise. An increasingly differentiated EU should be better able to deal with the particular concerns of the UK and of other countries too. It should also be better able to cope with further enlargement. The negotiation of the new euro treaty should allow for a revision of the existing EU treaties as well. Europe therefore has a full programme ahead, if it decides to face up to the future.

The rest of Europe has a strong interest in keeping the UK in the Union, including Scotland whichever way it decides to go in the referendum next September. A happy medium will therefore have to be found between the centralising and harmonising zeal of Brussels bureaucrats and others, and the *à la carte* approach apparently preferred by several British politicians. In fact, this is a golden rule that should be applied more generally on the condition, however, that obligations go hand in hand with rights: you cannot have the ones and not the others. Arguably, integration has gone too far in some policy areas.

The UK referendum planned to take place in 2017 with an in or out question will force a proper debate in that country with facts and arguments, thus going beyond a mere exchange of prejudices and stereotypes. And it will force politicians and others to take a clear stance in debate. An eventual British exit would be a big loss for Europe. It can be avoided when all the cards are on the table. Do not be afraid of democracy, much less so in a country with a rich democratic tradition.

Beating the odds?

It has to be said that the odds are against a new European grand bargain, including an ambitious euro treaty. Muddling through has become almost a way of life in a Europe caught in the midst of a big crisis which is challenging the fundamentals of the common project and the most advanced form of regional integration, namely the common currency.

The origins of the crisis are economic and not specific to Europe and European integration. But in the process, the crisis has revealed the weakness of common institutions, the fragility of intergovernmental and inter-country bonds, and the weak foundations of the permissive consensus that had allowed European integration to proceed at pace for decades, as long as it was capable of delivering the goods. It also uncovered all kinds of problematic children in the European family and exposed the limitations of political power set against a borderless economy that sets the pace and often dictates the rules.

Europe had been ill prepared. There had been huge mistakes in the setting up and the management of the euro, and also a great deal of complacency. Sometimes, Europeans give the impression that they believe in miracles – even worse, they seem to rely on them. However, they were also unlucky since the first big crisis of the euro coincided with the biggest international financial crisis for decades, perhaps also with the end of an era. They have so far avoided the worst but got low marks for their overall performance. And of course, it very much depends on which side of the fence you stand: in the South, it is hardly a pass mark and there are still difficult exams to follow.

Sure, several countries of the European periphery have largely themselves to blame. They had thought that membership of the euro was a free invitation to a party instead of an invitation to join a very demanding class; now they know. But it is also true that the general atmosphere was highly propitious and there were many international bankers around ready to issue free invitations to the party accompanied with gifts. The other countries later called upon to help the weaker members of the class found it convenient to lay the blame entirely on the weaker members instead of recognising that there was also a big problem with the curriculum, a systemic problem in other words.

The creditor countries may want to continue putting off a more radical overhaul of the existing system, because they do not want to take bigger

risks, also because they still do not have enough trust in the weaker members of the class being able to meet the requirements or because they prefer to think of their own short-term interests and not the long-term interests of the class as a whole. Who will take ownership of the European project when national political leaders are rewarded only for short-term national 'victories', while most of those forming the inner Brussels circle can only talk to each other and not to people back home? The trouble is that this may also be true of many MEPs.

As a result, Europe would continue to be weak, internally divided and inward looking for years to come: an ageing and declining continent, increasingly irrelevant in a rapidly changing world and with a highly unstable and poor neighbourhood. This is how an increasing number of people in Beijing, New Delhi, Pretoria and Rio de Janeiro see Europe today. The crisis has very much reinforced that negative view. Are Europeans willing or able to reverse this process of decline and growing irrelevance through closer cooperation or integration within the context of a redefined European project and a more active global role by recognising that strength lies in unity? A few apparently continue to live with the illusion of independent national foreign policies, while others dream of Europe as a kind of Switzerland writ large. But then, all kinds of events happen and disabuse such illusions. The recent events in Ukraine are only the latest example.

Has Europe, and much of the developed world, entered a period of slow growth, high volatility and risk, as well as growing inequalities, a world in which global markets and technology set the tone and politics adjusts, if and when it can? There is a big difference between market driven democracies and democratically regulated markets. The world has very much moved towards the former in this period of rapid globalisation and free capital movements. Historians[38] raise a question about whether fixed exchange rates and international capital mobility are compatible with democracy. One may also wonder whether in such a world there can be enough room for Europe between the global and the national or local.

Disintegration is no longer a taboo word.[39] It is being uttered all over the place and not only by diehard nationalists and the usual suspects. It may be still true that after sixty odd years, the Union 'disposes of a unique political glue'[40] that has proven its resistance during a big crisis. But the cracks are there and they are likely to grow bigger if the problems persist for much longer. There are strong centrifugal forces between and within countries.

The European project is not just an intergovernmental bargain; it has important implications for the domestic economic and social order. Today, social contracts are under strong pressure – in some countries, they are being literally torn apart. Trust in the financial system and in political elites has taken a big blow. The feeling of injustice and disempowerment is strong among many citizens who perceive the rapidly changing world around them as a threat. Popular reactions vary all the way from withdrawal to violent protest. Usually, they do not distinguish between national governments and the EU as the object of criticism or protest. More often though, they are tempted to seek refuge under the old protective umbrella of the nation-state: an umbrella that now has many holes.

It would be extremely short-sighted to simply lump together all kinds of protest as populist, and just dismiss them. There are surely many populists and demagogues around, but they have found fertile ground on which to sow. Let us instead treat populism and growing Euroscepticism as an alert; it may turn into a red alert when the results of the European Parliament elections are announced.

Under existing policies, the euro system hardly makes for a happy marriage. In a slow growth environment, with very high unemployment in some countries and persisting large debt, the strains could become unbearable, eventually leading to disintegration. The challenge, however, is not just to save the common currency. It is to provide a more effective management of interdependence, tame markets, create the conditions for sustainable development and more cohesive societies, strengthen

democracy and turn integration once again into a positive-sum game: a tall order admittedly, but also a challenge worth striving for.

If it succeeds, Europe would have some useful lessons to teach the rest of the world. After all, if the regional experiment of joint management of high levels of interdependence has reached its limits and needs to be reversed, what are the prospects for economic globalisation in an increasingly multipolar world where no hegemon can any longer dictate the terms?

True, membership of the euro area is highly diverse. With the benefit of hindsight, a benevolent dictator would have arranged for a different set of members. Optimum currency areas exist only in economic textbooks. In real life, they are created. Are Europeans ready to match economic and political integration with the monetary integration that already exists? It would constitute a great leap forward, but yet not an impossible one to make. If some people show the way, others will follow. It is all about seizing the moment; a big crisis can either make or break.

On the other hand, some European countries will certainly not be prepared to follow. There should be room for them under the bigger European roof as members of the single market and much more. One day in the future, those countries may opt for more obligations and more rights. In the meantime, the UK and Sweden – Poland also, waiting to join the euro eventually – should continue as members of the EU and play an active role in different policy areas, including foreign policy. More integration for some countries should therefore be accompanied with more differentiation and flexibility for others. The same recipe cannot apply to all 28 members of the EU. More flexibility and differentiation should also facilitate further enlargement in the future.

Europe should be inclusive and look for ways to accommodate diversity and make the best of it. More integration where needed and more national or local responsibility wherever possible could be a good motto for Europe coming out of the crisis. The alternative risks undoing what made us proud and strong for many years.

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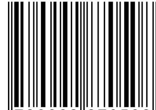
40. Luuk Van Middelaar, *The Passage to Europe*: *How a Continent Became a Union*?, Yale University Press, 2013, p.xi.

The eurocrisis has fundamentally divided Europe between creditor and debtor states, between eurozone countries and the rest. Even within member states divisions run deep. Trust is low, the economics flawed, and the politics toxic. In this Policy Network pamphlet, Loukas Tsoukalis presents the case for a new grand bargain to rescue the European project. The work is published in partnership with major European thinktanks in France, Germany, Greece, Italy and Spain. Translated versions will be disseminated in all six languages.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