Europe and the World: 2015--????

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"Cecily, you will read your Political Economy in my absence. The chapter on the Fall of the Rupee you may omit. It is somewhat too sensational. Even these metallic problems have their melodramatic side." -- from *The Importance of Being Ernest* by Oscar Wilde

Earlier this year I had the enjoyable privilege of debating Manuel Barroso, then just retired as President of the European Commission, before a knowledgeable audience that included international students, at the annual Estoril Political Forum in Portugal. Our topic was Europe and the World in the previous decade. Mr. Barroso is a shrewd and good-natured debater; he is popular with the students at the Catholic University of Lisbon where he is now a distinguished guest lecturer; and he certainly didn't lose the debate. Against the background of the Euro and refugee crises, however, he was arguing uphill. His audience was more anxious about European developments than in earlier Forums. And like other speakers supportive of Euro-integration at the 2015 Forum, he made clear he was open to reforms that would accommodate a greater diversity of national arrangements within EU rules and institutions.

That greater willingness is a response to a decade that has been neither easy nor comfortable for the European Union. In

retrospect the long grumbling crisis afflicting it began just over a decade ago with the rejection of what was supposed to be its Constitution by French voters in a May 2005 referendum. One month later Dutch voters rejected it too. At that point the Constitution seemed to be a dead letter. But it was promptly brought back to life in 2007 in the form of the Lisbon Treaty. Essentially the Treaty was exactly the same set of reforms—an extension of qualified majority voting, the transfer of more powers to central EU institutions, legal force granted to the Charter of Rights, etc.—presented as a new Treaty rooted in amendments to existing treaties.

Crucially, these amendments required no referendums for ratification with the sole exception of Ireland whose constitution required a referendum on any constitutional change. Like the French and the Dutch, however, the Irish then rejected the Lisbon Treaty. They were then persuaded to vote again in order to get the right result. That duly happened. And the Lisbon Treaty became a kind of de facto EU Constitution under a different name.

Stand back now and consider the implications of those early events. They demonstrate three characteristics of European Union policy-making as we have increasingly experienced it since the Treaty of Rome was signed in 1957: uniformity, centralization, and a single permitted direction of travel.

Uniformity? National vetoes were largely replaced by qualified majority voting; mutual recognition of national standards was

replaced by centralized bureaucratic harmonization of regulations; all states were to live within the same European rules and institutions except for a few temporary exemptions such as Britain and the Euro.

Centralization? Lip-service is paid to the principle of subsidiarity in the Lisbon Treaty, but in practice more powers were moved from national parliaments and governments to EU bodies in Brussels. Government thus became even more remote from the voters (though not from pressure groups, lobbyists, or corporations.)

The same direction of travel? Here the principle of an "ever-closer union" was upheld and advanced at Lisbon. If people voted against it, they were either ignored, outmaneuvered, or, worse, compelled to vote again until they gave the required answer. We might call this the principle of historical inevitability applied to Europe: EU member-states cannot legitimately reject ever-closer union. Elections may come and go, but they can't be allowed to halt or reverse it. It is built into the EU's legal and constitutional foundations.

Whether these things are good or bad in themselves, they made Europe less democratically accountable and more remote—a Europe of politicians, NGOs, and corporations. Not surprisingly their most obvious result was the alienation of the voters.

The 2014 European elections had the lowest turnout—at just over 42 per cent—since the first EU elections in 1979.

Admittedly, one or two countries bucked this trend and their turnout rose. The best countervailing example was Greece where the voters had a very obvious interest in Europe, namely bailout money, and where the turnout rose to almost 60 per cent. You can, if you wish, treat that as an encouraging sign.

This low EU turnout is only the tip of the iceberg of alienation, however. Mainstream political parties associated with the European idea and Lisbon somehow look frozen, static, and uninspired, winning only those voters who cast ballots in the same dutiful civic spirit as they give blood donations. Such parties are kept going by past loyalties from other times and other issues. Their victories serve to increase voter alienation. More voters drift to the so-called "populist" parties of Left and Right that in the last decade have risen throughout Europe—in France where the National Front gets a third of the vote, in Sweden where the Swedish Democrats get over 20 per cent, in Denmark where the Danish People's party (a party devoted to protecting Denmark's welfare state against immigration), in Spain with Podemos, in Greece with Syriza and Golden Dawn, in Italy with Beppe Grillo's party, in Hungary with Jobbik, in Britain with UKIP, in Scotland with the SNP, in Ireland with Sinn Fein. Some of these parties are respectable, like UKIP; some are tainted with racism and anti-Semitism such as Jobbik or the Swedish Democrats; some are tainted with murder such as Sinn Fein and Golden Dawn. But all these eruptions are the result of popular resentments on the part of very large numbers

of voters at the fact that the mainstream "legacy" parties offer them no choice on the issues they consider important—including further European integration but by no means confined to it.

Voter disaffection, bad as it is, is less damaging on a daily basis than the distorting impact of remote bureaucratic politics on policy. In the very nature of things, if you move political decisions to remote bodies far from the voters, if you closet decision-makers with corporate lobbyists and ideological NGOs such as Greenpeace, if you ask them to be guided by a principle that all decisions should be infused with movement towards ever-closer union, then you will get policies that are biased towards special interest coalitions, remote from voter wishes, almost impossible to change once they have been endorsed by the various "players" or "stakeholders," and in the end policies that are "idealistic" at best, unrealistic at most, and utopian at worst.

Consider the three policies at present dominating political debate and television news:

1. Europe's de-carbonization energy policy would phase out fossil-fuel energy and replace it with subsidies for "renewables." That was adopted in a high spirit of moral self-congratulation that Europe was giving moral leadership to the world. It has resulted in very high energy prices for consumers and industry, the transfer of German investment into factories abroad, threats to the future of Poland's coal industry, and wasteful investment in such projects as wind

farms that generate very little energy at very high prices. Not surprisingly, this policy is being abandoned in phases. It represents waste of every kind. No one will ever apologize for it.

2. The Schengen agreement was designed to realize the dream of a Europe without internal borders. In a world of global migration flows, however, such a dream can only be realized safely if there is effective control of Europe's external borders in the first place (and even then only if a legal regime exists that allows prompt deportation.) Neither condition was put in place before Schengen. Accordingly "border" EU states are overwhelmed and respond by encouraging unwelcome migrants to move on to other countries. The final result you again see on your television screens—a sporadic series of individual invasions of Europe, some violent, that no one knows how to halt or reverse or, on the other hand, to accommodate.
3. The long slow agony of the Euro. Robert Samuelson in the *Washington Post* has without exaggeration described this as the "single biggest public policy failure since the Second World War." And it was a readily predictable one. It was always known that the Euro 17 were not "an optimal currency area." But Europe's leaders decided to admit out-of-kilter economies such as Spain, Portugal, and Greece because that represented a huge step forward towards ever closer union. In fact it has set European integration back, except in a perversely destructive way, by imposing

> recession without end on Mediterranean Europe and exacting large sums of taxpayer finance from Northern Europe. Rates of unemployment in southern Europe have risen nonetheless to levels between 15 and 25 per cent and youth unemployment to around half the young population.

In fact the Euro crisis has really been two crises: a financial funding crisis and an economic integration crisis. And both of them are illustrated with particular clarity in the case of Greece.

Greece was never well-suited to the Euro. Economically it was about one-third less productive than the EU average. Financially it had a weak currency, a tendency to inflation, and a history of devaluing in order to accommodate higher real costs. Politically it was a weak democracy with a corrupt establishment and a party system rooted in clientalism. Its application for Euro membership relied on financial statistics that had been cleverly massaged. But the symbolism of the Euro extending to "the birthplace of democracy" was such that everyone turned a blind eye to such discouraging realities. And before the financial crash of 2008, the Greeks took advantage of the Euro-illusion that Greek debts denominated in Euros were of equal worth to those of Germany. Athens went on a borrowing binge.

The Euro's funding crisis arises from the fact that the financial markets began to suspect that this implicit promise of the Euro—that Germany stands behind the debt of Greece—was

unreliable. For as long as everyone believed that promise, namely for the first decade of the Euro's existence, the financial market lent money to the Greek government on the same terms as to Berlin. That meant much cheaper rates than Greece could have obtained when it had the drachma. So governments overspent, the private sector over-invested (and mal-invested), and consumers enjoyed themselves. It was good while it lasted. But when doubts about the Euro guarantee spread, lenders demanded higher rates of return from higher-risk countries. And a cloud fell on the Euro.

Greece was foremost among those countries facing the prospect of sky-high interest rates. Athens could no longer simply issue Drachmas to pay its debts, and its ability to pay with Euros was constrained by a European monetary policy set to suit German interests. Unable to afford issuing official debt denominated in Euros, Greece (and other Mediterranean countries) faced the dire prospects of defaulting on their debts, running out of foreign reserves, and being forced to leave the Euro.

To avoid such an outcome (which they saw as disastrous for the cause of ever closer union), the European Central Bank, the EU itself, EU summits, and the IMF have proposed and increasingly implemented a series of measures: another Fiscal Stability Pact (the first one having been abandoned by France and Germany in 2002), Euro-bailouts for countries facing default, government bailouts of banks, vague hints of future Eurozone debt mutualization, the beginnings of a fiscal and banking union, and

the eventual future creation of a Eurozone transfer union. Almost all of these measures were disavowed in advance of the Euro's creation in order to persuade the reluctant Germans to surrender their beloved D-Mark. ("No bailouts" was the exact and unambiguous wording.) They have little democratic foundation in popular support. And the price extracted from Greece for these bailouts has been the imposition of harsh cuts in state spending, "haircuts" on investors and private bank depositors—in political short-hand, "Austerity."

A secondary but important cost of such assistance has been loss of sovereignty—and by extension of democracy—to the countries seeking bailouts. Fiscal, monetary, and social policy in such countries has been crafted in response less to the voters than to the demands of external authorities, generally known as "the Troika." In the case of Greece, a government decision to hold a referendum on Euro policy was revoked, the prime minister who proposed it was replaced under pressure by a technocrat, the governing social democrat party was reduced to a handful of seats, extremist parties of Left and Right rose in the polls, the extreme-Left Trotskyist party, Syriza, then won two elections, and a referendum that Syriza called and won against "Austerity" policies was abandoned under strong pressure from Brussels. In modern parlance democratic government has been replaced by supra-national governance which might be defined as "government without accountability."

We cannot yet know the full unintended consequences of such intervention. After the bailout of Cyprus, for instance, (in which account holders in solvent banks lost all their deposits above 100,000 Euros) no wary investor will ever again keep more than 100,000 Euros in a European bank account. They no longer feel their money is safe. As soon as a country looks risk-prone, capital will fly. And ill-feeling between those countries receiving bailout money and those countries providing it has erupted in bitter rhetoric and xenophobia.

Yet despite the harshness, inequity and undemocratic nature of these policies, European leaders have recently been arguing that they have met the first criterion of a policy: they have succeeded. The Euro is safe. Neither Greece nor any other country has defaulted.

That may be doubted. The Euro-bailout crisis has never really gone away even if it has not yet resulted in a default or a departure from the Euro. Still, let us assume that the funding crisis of the Euro has now been solved. Even if so, that would still leave the Euro's second crisis—the single currency locks Greece and other Mediterranean countries into a vertiginously unfavorable de facto exchange rate. The only way to solve that problem within the Euro is for the workforce in Greece, Portugal, Spain, and Italy to improve their productivity and/or to reduce their incomes in a process known as "internal devaluation." Greece would have to devalue its putative exchange rate—to reduce its cost structure relative to

Germany—by about one-third. Very few economists believe that this can be done at all; no economist thinks that it can be done quickly. And while these countries are struggling to reach this receding objective, they will be locked into economic austerity—and northern Europe will be locked into paying an endless flow of compensatory subsidies to them. That means a loss of wealth at both ends of the transfer. In the long term, Greece would be part of one large Mezzogiorno eternally dependent on other countries' taxpayers. We already see this happening in such statistics as 56 per cent youth unemployment in Spain and French migration to the English Silicon Valley between Dover and London.

But the sharpest pain is that permanent recession (aka Austerity) is not the problem; for supporters of the Euro it is the solution. Austerity is what you have to do in order to keep countries with very different productivity levels and cost structures within the same currency. Let me quote Martin Wolf of the *Financial Times* on Greece from two years ago:

"According to the OECD . . . real private demand fell by 33 per cent between the first quarters of 2008 and 2013, while unemployment rose to 27 per cent of the labour force. The only justification for such a depression is that a huge fall in output and a parallel rise in unemployment is necessary to force needed reductions in relative costs on to a country that is part of a currency union. Since the Greeks want to remain inside the eurozone, they have to bear the resultant pain."

Now, sometimes political leaders say that they want their country to remain in the Euro while rejecting Austerity. But this choice does not exist. For Greece—as for Portugal, Spain, and Italy—to remain in the Euro is to choose Austerity.

So what can be done? As we have seen the Greek Euro crisis combines two questions: should Greece leave or stay in the Euro, and should Greece default or pay its debts. In fact Greece has already defaulted. It did so in 2011 with a grand "haircut" of private investors which scalped a full seventy per cent of their loans. This was orchestrated by EU finance ministers and the European Central Bank and disguised as a civilized re-structuring of debt. But a default had occurred all the same.

That acknowledged, there are four possible options:

First, Greece could both leave the Euro and repudiate its international debts. This would mean cutting Greece off from private sector investment and such loans, subsidies, and grants as are available from international agencies and European governments. Argentina is sometimes cited as a successful example of this strategy. But Argentina was the undeserving beneficiary of a raw material boom. It is now hitting the buffers. Lacking Argentina's raw materials, Greece would hit the buffers far earlier—and therefore its public and private sectors would both face austerity on a far greater scale than at present. This policy would maximize the medium-term turmoil that leaving the Euro would present anyway but the falling Drachma would at least enable Greece to reduce the international prices of its

goods and services so that it would eventually grow its way out of trouble. Without foreign investment for many years, however, its recovery would be slower and more painful than necessary.

The second option is for Greece to default while remaining inside the Euro. That seems possible in principle—just as California could default within the “Dollar-zone.” But it is the worst possible policy. Greece would be committed to paying for its imports in what would be wildly expensive Euros. It would be locked out of the international markets and deprived of foreign investment. As under option one, it would have to impose a more savage austerity than now on the country. And it would not enjoy the long term stimulus of a weaker currency. All that said, change a few words and it bears a curious similarity to the status quo (see option four.)

The third option is that Greece would leave the Euro but promise credibly to pay its remaining debts. Admittedly those debts would have to be re-denominated. The whole point of Greece leaving the Euro would be to adopt a new Greek Drachma at a value of, say, half that of the Euro. In theory (and in the immediate term) switching to a cheaper currency would both devalue the total of Greek indebtedness by about half and increase the country’s ability to pay by stimulating exports and tourism. It would not be that simple, admittedly. Very likely the Euro zone countries and the ECB would scale greatly back any financial assistance to Greece. But everyone has an interest in solving the Greek problem with as little instability as possible.

So Europe might well find it useful to grease “Grexit” with some short-term financial assistance. Indeed, if the economy began an early recovery, the Drachma would presumably rise accordingly so that the bond-holders would get back more of their money than now seems likely.

The fourth and final option is the status quo: Greece would remain inside the Euro and committed to full repayment of its loans which would naturally be in Euros. The status quo is always an option, just as there is always a Plan B. As it has developed over the last four years, however, the fourth option seems to rest on an indefinite transfer of resources from northern Europe (Germany, Holland, Belgium, the Baltic States) to southern Europe (Greece, Portugal, Spain, and Italy.) In Greece, which is the extreme case, the bailouts, loans, and other forms of assistance from the EU and the IMF are now so extensive, have resulted in such a large Greek indebtedness, and enjoy so small a prospect of repayment on any reasonable timetable that they amount in reality to a permanent running default. Hence option four is really a dishonest version of option two.

In modern European politics—which should not be confused with the real world—the choice lies between options three and four. Most free market economists and the private sector would probably choose option three because it seems to offer a greater and quicker prospect of economic recovery. Most governments favor option four because it seems to include a greater chance of

persuading the Germans to continue sending money—and indeed to send more money—to themselves and their neighbors.

This is the classic divide between Left and Right, socialist and liberal (or conservative liberal), the free market and government regulation. And it came to a head earlier in July 2015 at the Brussels EU summit on the latest Greek bailout. The choice in retrospect was whether to grant Greece a substantial loan within the Euro with vague promises of actual debt relief later or to grant up-front debt relief now in return for a temporary Grexit. Alex Tsipras, Greece's prime minister, argued for the first; surprisingly Germany's finance minister, Wolfgang Schauble, advance the case for the second. Tsipras won that skirmish but the battle is far from over.

To begin with, the deal that Tsipras got from the EU and the IMF can't work. It assumes that the Greeks will deliver on tax hikes, spending cuts, and privatization receipts. They won't. They didn't deliver on previous occasions, and this time almost every Greek will conspire to outwit the regulations that Brussels imposes on them. The deal also assumes that the Germans will ignore Greek backsliding and underwrite Athens's debts come what may. German support for the latest bailout won't survive a fourth demand from Athens. And as long as Greece remains in the euro, it will need regular infusions of cash from other Eurozone members, as a post-crisis IMF report acknowledged.

As the crisis continues, therefore, the next stage of the political divide becomes clear. The Left parties across Europe—Syriza in

Greece, Podemos in Spain, and Beppe Grillo's Five Star Movement in Italy—are starting to coalesce around the case for a "transfer union." This is naturally attractive to old-style socialists and hard leftists because it elevates income re-distribution from domestic to international (or intra-European) politics. That's why Tsipras swallowed tough fiscal medicine in order to remain in the euro. Whether or not he delivers on his promises, he calculates that they will be enough to keep German money coming, maybe indefinitely. Being outside the euro would have limited any Euro-cash to that one-off "goodbye" settlement.

Other Left parties will be quick to see where this ideology takes them. Indeed, it has been developing in opposition to "Austerity" for several years: poor countries should not repay loans that were "predatory;" democracy must wrest back power from the markets; etc. In fact markets enjoy no power over those countries that don't want to borrow their money or that pay investors an agreed rate of return. Their sole power—that of refusal to lend—is effective only against those seeking to rob them. But that description covers a number of European and other governments who therefore calculate that they could make an end-run around the markets by joining richer countries in a transfer union. That would guarantee them regular subsidies from more prosperous members of the Eurozone. Given these incentives, their ideologies are likely to morph gradually into an international version of "Can't Pay, Won't Pay"—the fun-

anarchist slogan that began life as a title of a play by Dario Fo, the Nobel Prize-winning playwright and (not coincidentally) the informal ideologist of Italy's Five Star Movement.

It is this developing ideology that alarms Germans, especially the center-right, since their country would be its principal financier and victim. Schauble wanted a fiscal union to balance the politics of a transfer union and to discipline the budgetary policies of weaker euro members. But he was outvoted in Brussels by Merkel, the social democratic half of the Grand Coalition, French President Francois Hollande, the European Commission headed by Jean-Claude Juncker, and Uncle Tom Cobbleigh and all, who clung to the superstition that any departure from the euro would doom not only the single currency but the European Union itself. That is almost certainly the opposite of the truth. "Europe" is more threatened by failed bailouts than by the exit from the euro, temporary or otherwise, of countries it has plunged into recession.

But orthodoxy carried the day. All then compromised on a bailout in which the terms were made painful to signal to Greece, Syriza, and the Mediterranean Left that any transfer union, if one happened, would be accompanied by a fiscal union so tough that nations would go to the extreme lengths of balancing their budgets and paying their debts to avoid it.

The wider European politics of such a bargain, however, are not favorable to fiscal discipline or economic growth.Even while the bailout was being celebrated, there was a reaction to its

“harshness.” Soft-left, progressive, and bien-pensant opinion was shocked to discover that a fiscal union might limit national sovereignty, override national democratic decisions, and treat debtor nations as sub-colonial units—even though leading Eurozone figures have argued its necessity for these very purposes for the last half-decade. Once they saw the undemocratic imposition of austerity in action, the progressives balked—with *Guardian* columnists in Britain even talking wildly of voting against EU membership. After all, Greece would get the money and nobody in particular would finance it. So why worry?

Syriza and the Hard Left were probably surprised too, but pleasantly so. They will be happier to accept harsh punishments on paper in return for hard cash because they now know that Europe’s vast soft-left lumpen-intelligentsia will protest if any real attempt is made to collect. Astonishingly, the IMF promptly discovered that the Greeks needed more money to survive than the IMF itself had calculated *the previous day*.

Naturally, all these threats to fiscal and economic stability worried conservative opinion throughout Europe. It was already shifting, as I found at the Estoril conference. A German Christian Democrat, unapologetically Euro-federalist, surprised the conference with the argument that forthcoming Brexit talks with Britain were less a danger to the continent than an opportunity to reform Europe on less centralized, regulatory, and socialist lines

This seems a good point to concede that I am not opposed to the Euro as such. The fact that this particular single currency, covering Greece and similar countries at this particular time, cannot work does not mean that a differently structured single currency cannot work. A workable euro is a possibility. Getting to it will be hard and painful; but not as hard and painful as remaining within its destructive disciplines; and it can be done. But how?

Consider this: You often hear supporters of the euro say such things as: "Well, we should never have let Greece in. It was a mistake." Why not then remedy the mistake and remove Greece from the euro as Schauble suggested? (Temporarily, it is true, but as the French say, "nothing lasts like the provisional.") Other critics have suggested that Germany should leave the euro — which would mean the remaining euro would be sharply devalued against other currencies. That would, in a single bound, reduce the difficulty for countries such as Portugal of restoring their competitiveness. But Germany will probably not wish to surrender its leading role in the European Union—or the trade and economic benefits it gains from having an undervalued currency—that such a decision would entail.

That leaves the proposal for restructuring most often heard (and the most plausible one): namely, the creation of two euros — a southern euro and a northern one. The former would be immediately devalued against the latter, either by fiat or by the markets, restoring southern competitiveness, reducing moral

hazard, and removing the need for massive cross-border monetary transfers. This would create difficulties, of course. The transition pains upon leaving the Euro would be harsh—but they would be temporary. Germany would find that because its artificial undervaluation in the present euro was gone, its export success would be harder to maintain. France would have to decide between its interests, which would dictate joining the southern euro, and its prestige, which would require membership of the northern one. Watching Paris agonize over that would be entertaining.

Over time, the member states of Euro 1 and Euro 2 might gradually converge, eventually restoring a unified euro. But that would be shaped by practical evolution more than by theoretical ambitions.

And if our experience with the Euro suggests that a system that is flexible and responds to change is preferable to a rigid straitjacket, then surely in a continent as varied as Europe, in which countries differ culturally and politically as well as economically, we should offer different levels of commitment on different topics to different member-states; we should seek to accommodate differences by allowing member-states, as far as possible, to compete with each other on tax and regulation rather than imposing the same system on all via centralized bureaucratic harmonization.

Look at the map of Europe and consider its history. It was that kind of decentralized Europe which enable freedom to flourish

and spread and which accordingly invented the modern world. And if someone tells you that "European interests" or "European values" require this or that uniform policy, you should repeat the sentence but in doing so, replace "European" with "Finno-Portuguese." (E.g.: Finno-Portuguese values demand that we admit limitless numbers of mgrants."

We should not expect an EU of more than 30 members (and still growing) to retain the same one-size-fits-all structure that was suitable to the original six-member European Economic Community and to the slightly larger groups of the 1970s and 1980s. Some basic structural unities would remain —continental free trade, some legal principles, mutual recognition of national regulations, mechanisms of political consultation and cooperation both regional and European— but in other respects different countries would adopt different elements from the à la carte menu of European unity. In fact, though we sometimes forget to notice it, that principle has already been adopted in relation to the Euro. Several EU states remain outside it, and those East European states that have promised to enter in due course will not now do so in any foreseeable time scale.

Well, that same principle could be applied more widely, with different European countries adopting different levels of integration in different areas. And if some countries — Germany, France, Benelux — want to forge ahead to a greater degree of political integration, maybe evolving into a new single European nation, the rest of us should be happy to accommorate

and even endorse this. It would be the kind of experimentation that federations are supposed to encourage and foster. It is why the federal principle of jurisdictional competition (or the legal underpinning of free trade) was invented. This kind of variable-geometry Europe, as it is called, might actually produce faster integration with less pain than the kinds of more intense integration now being pushed forward.

Nor, finally, would such a European structure threaten democracy in Europe's nation-states as uniform structures such as the Euro have done. The latest such case is the announcement of the Portuguese President following the recent election that he will not call upon the euro-skeptic parliamentary majority of the Left to form a government because it would threaten Portugal's membership of the Euro. The list of such cases is growing.

As Miss Prism told Cecily: Even these metallic problems have their melodramatic side."