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A Rebound, not a Break-up: The Political Implications of the Economic Crisis for the European Union

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Will Europe break up? In the past six months, this question has suddenly gained currency and is now being asked not just by worried and introspective Europeans, but by observers across the globe. And given the scope of current economic turbulence, there is no shortage of nightmare scenarios that could lead to that end. The Eurozone could implode under the tensions generated by this first major test to its unity, as Milton Friedman famously predicted. The common market, which remains the cornerstone of the European Union, could unravel under the wrenching pull of stealth protectionism. EU institutions could increasingly atrophy from the glaring lack of crisis leadership and the tensions generated by publics demanding purely national solutions. Eastern European member states could suffer fatal blows and revolt against the perceived abandonment of the West, while other hard hit countries – from Ireland to Greece and Latvia – could turn their backs on a European Union sold to them as safe haven.

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Not so fast. While there have been a number of worrying developments caused by the economic downturn, and while this is no time to be complacent or lack imagination, there are still reasons to believe that Europe will not only survive, but may even benefit from this crisis. A case could be made that, in the final analysis, the net effect of the downturn will be to force greater unity upon Europe. Current tensions can certainly be interpreted as the first cracks of an impending break-up, but they can also be seen in a very different light – the normal and adaptive reaction of a healthy body to stress. That body may suffer as a result of the assault, and will no doubt feel miserable for a time, but, as the saying goes, that which doesn't kill you, only makes you stronger. After all, if history is any guide, this would be nothing but a classic with respect to European construction – where a period of dire crisis is followed by a rebound and the strengthening of the EU as an ever closer union. Things go horribly wrong before they get better – but a full recovery occurs precisely because things got so bad. In other words, the events we are witnessing may foretell not so much the beginning of the end as the end of the beginning for Europe.

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To assess the political implications of the crisis, it is necessary to determine first what the appropriate criteria for evaluation are, especially in terms of expectations and time period. The current threat of disintegration is so large that one could argue that simply weathering the storm would be an achievement. A second school of thought may use a maximalist yardstick: because EU leadership has been lacking on bailout coordination or help for Eastern European member states, the crisis has already exposed the union as a superficial construction built for fair weather only. In this light, even the recent innovations to deal with the crisis, like the invention of an implicit "no-default clause" for Eurozone countries, as will be discussed later, are seen as a bare minimum and an inadequate response to the challenges before us.

My position is distinct from both these schools of thought. First, while some lessons can already be drawn from the crisis, it is too soon to pass a comprehensive judgment on recent events and their impact. We still don't know the full depth of the economic downturn, nor can we fully gauge its social and political consequences. The worst may still lie ahead for Europe. At this point, all we can offer is an assessment of Europe’s initial response and tendencies and speculate on future possibilities. Second, rather than focusing only on the short-term implications of this crisis, my time frame for evaluation is the middle term – the next 5 to 10 years. Finally, my expectations for EU institutions are not maximalist; I do not expect that the crisis will precipitate a super-federal EU state, nor do I wish it would. I am hoping for more than survival, however, and if current tensions can bring about new instruments of solidarity, force more unity and coordination among states, and demonstrate that the institutions are here to stay, then the EU will have not only passed its first serious test but will ultimately emerge stronger as a result.

<u>1. Doomsday scenarios: Be afraid. Be very afraid.</u>

a) A populist and nationalistic wave against Europe

There is no reason why the current crisis should remain consigned to economic textbooks. As history shows, major economic downturns tend to degenerate into social crises, which in turn create political turmoil. The most salient analogy here, of course, is Germany in the 1930's where economic distress and social upheaval led to the rise of Nazism. Massive unemployment – now forecasted to reach up to 26.5 million in the EU – could bring social unrest, demonstrations and violence (like that seen in Latvia in January 2009). Several negative outcomes could emerge from this deteriorating climate. A populist leader elected in a member state could take advantage of the situation to use Brussels and neighboring countries as scapegoats and start implementing beggar-thy–neighbor policies. A more mainstream government could conceivably do the same if sufficiently pressured by the street. This could signal to other governments that it is acceptable to adopt uncooperative policies, and in turn, encourage them to follow suit and further poison the European climate.

We have already seen some signs of backlash against EU policy, especially in the labor market. The UK is certainly the most open country in this respect, with nearly 15% of its current workers foreign born. This fact helps explain the wave of strikes launched across the country in early 2009 against the hiring of foreign workers, with the slogan taken (partly out of context) from Gordon Brown's own words, "British jobs for British workers"[1]. That slogan makes clear the common source for such scenarios: While free-market and free-

[1] Nico Hines, Andrew Norfolk and Christine Buckley, "Wildcat strikes over foreign workers spread across Britain", *Times Online*, January 30, 2009.

circulation rules are European, social policies and state aids for ailing industries are paid for by national budgets, and in times of crisis, taxpayers want to make sure that their money is put to use in their country.

How likely are such scenarios of populism and vicious cycles of go-it-alone policies? So far, there have been surprisingly few gains made by extreme-right and extreme-left politicians, or by Euroskeptic political groups across the EU, including in Eastern and Central Europe where the impact of the crisis is most severe[2]. Moreover, the analogy of the 1930's seems flawed in many respects: the social crisis was much deeper then, governments were not as convinced of the importance of maintaining international discipline, and the catastrophes of 1930's had not yet happened and thus had not yet been etched into European consciousness. While anger may be a very powerful emotion, it is counter-balanced in public opinion by another very powerful emotion –fear. The fear of a situation made even worse by rash actions and inward-looking policies has had a moderating effect. It is striking that deteriorating economic conditions in France have led neither to massive demonstrations nor to a rise of anti-Sarkozy forces (indeed, at this point, the ruling UMP party seems poised to win the European elections, which would be a political anomaly).

b) The slow death of the common market

A second set of scenarios is largely a variation on the first, but centers on the common market, the cornerstone of the European project since the 1950's. While a populist leader or an endangered government could enact blatantly protectionist decisions, it is more likely that the intra-EU free flow of goods and capital will be threatened by stealth protectionism – measures that distort the common market in indirect ways. There have already been a few examples of these in the recent months, and their proliferation could quickly lead to recriminations among states and a deterioration of the trust and credibility on which EU economic life relies.

Faced with the crisis, some governments have encouraged their population to "buy national", like the "buy Spanish" campaign orchestrated by Miguel Sebastian, Minister for industry, tourism and commerce[3]. If no government has actually required national economic actors, even those helped by state bailouts, to "buy national", some have come very close, especially in the process of rescuing or even nationalizing banks. By "making public support conditional on domestic lending, thereby crowding out foreign-owned competitors," some states like the UK have come close to crossing the red line[4]. The French auto bailout raised similar concerns. When Sarkozy declared on February 5th, "If you build a Renault plant in India to sell Renaults to Indians, that's justified, but if you build a factory [...] in the Czech Republic, to sell cars in France, that's not justified," he was hinting at possible restrictions incompatible with EU rules. But the European Commission eventually cleared Sarkozy's auto bailout plan, implying it did not cross any red line (see more on this below).

More generally, one of the biggest dangers for the common market is not the illegal strings attached to bailouts, but bailouts themselves. Some states are tempted to take advantage of the crisis and go beyond what is permissible under EU rules, citing extraordinary times. And it takes time for the Commission to review each individual bailout and all investigations, like the one recently launched on the Dutch rescue of Fortis Bank, are made *ex post*. Finally, the inequality between large states, which can afford stimulus packages and state aids to their

[2] Euractiv.com, "Crisis 'not helping' Eurosceptics gain consensus", March 27, 2009.

[3] Victor Mallet, "Spain unveils €4bn aid for motor industry", *Financial Times*, February 14, 2009.
[4] Wolfgang Münchau, "The eurozone needs a co-ordinated strategy", *Financial Times*, April 27, 2009.

own industries, and small countries which cannot, introduces unfair competition and also poses a serious risk to the common market. While there is nothing illegal here, this situation could lead to resentment, all the more so given that some small states will be in an increasingly difficult financial situation.

c) A break-up of the Economic monetary Union (EMU) or a major bank collapse

A third doomsday scenario focuses on the 16-country Eurozone, and more specifically on the possibility of either seeing the euro unravel or seeing countries leave the Eurozone. Here, some of the biggest fears are linked to the phenomenon of bonds spread. As Jean Pisani-Ferry explains, "[Eurozone states] all looked the same for a long time. The reckless and the virtuous ones, the sneaky and the upfront ones, all the member countries of the euro area were treated identically, or nearly, by capital markets"[5]. But with the crisis, bond markets are getting very worried about the ability of some countries (Spain, Greece, Portugal, Ireland and others) to pay their debt back. So "they demand a higher premium on government bonds issued to raise the cash. The more the doubts and debts, the more the markets ask governments to pay to service their borrowing and all the more indebted governments become," explains Bruno Waterfield in Brussels. "This is the vicious spiral that threatens to tear both the euro and the EU apart"[6]. Faced with growing economic and social pain, countries which now can't use either their monetary or budgetary instruments may be tempted to default on their debt or even to opt out of the Eurozone. "EMU break-up clearly remains a strong trading theme and a number of investors continue to anticipate that at least a few countries will try to go back to their old currencies," said Thomas Stolper of Goldman Sachs in early 2009[7]. What would happen then? "A sovereign default would inevitably trigger contagion, Pisani-Ferry explains, as financial crises always do."[8] This, in turn, could endanger the whole Eurozone.

But this is not the most likely scenario, and bonds spread has tended to stabilize and then narrow sharply in April 2009. As for the risk of seeing a Eurozone country default on its debt, Berlin and Brussels have stated that they would intervene beforehand, thereby inventing a "solidarity clause" to complement the "no bailout clause". And of course, it is hard to see how the cost of opting out could be lower than the cost of staying in.

But this is not the end of possible troubles. A more likely doomsday outcome would be linked to a major bank, not a small country, collapsing, as Nicolas Véron of the Bruegel Institute has noted[9]. There are two potential scenarios which should keep Europeans awake at night. The first one would be the inability of small and weak countries to participate in an EU-wide bank bailout, or even to rescue one of their own banks, because of their financial difficulties and of the excessive cost of borrowing on the bonds market. The second one is equally worrying. It may be that Europe is unwilling, or institutionally unable, to coordinate the rescue of one or several of its huge multinational banks. After all, according to the IMF, European banks hold more bad assets than American ones ($1,426bn versus $1,050bn) and have written down much less. Capital

[5] Jean Pisani-Ferry, "The euro sorely tested by national crises", *Le Monde*, January 27, 2009, English version accessible at http://www.bruegel.org/10742

[6] Bruno Waterfield, "European disunion: Is the EU cracking up?", Bruno Waterfield blog, February 9, 2009.

[7] Quoted by Peter Garnham, "Fear over weaker states hits euro", *Financial Times*, January 17, 2009.

[8] Pisani-Ferry, op. cit.

[9] Cf. Jean-François Jamet, Franck Lirzin, "L'Europe à l'épreuve de la récession", Questions d'Europe n°130, http://www.robert-schuman.org/question_europe.php?num=qe-130, and Nicolas Véron, "Le noeud gordien des banques européennes", *La Tribune*, March 11, 2009.

injections of $275bn would be required in the US, versus $500bn in Europe[10]. If countries can't bail out their own banks, will Europe really be in a position to take over?

d) A new iron curtain between East and West

Eastern Europe is in a particularly precarious position with respect to its financial situation, and a fourth worst-case scenario centers on the exacerbation of division between East and West by the crisis. Since the end of the Cold War, Eastern Europe has received massive injections of investment and capital from the West, and this movement was encouraged by the accession of most of these countries into the EU[11]. But the crisis has caused a rapid decline in exports to the West and repatriation of funds by Western banks – especially from Austria, Sweden, Italy, etc. This has led to currency devaluation (except for Slovakia and Slovenia, which are already in the Eurozone), increased financial difficulties (especially for some loans which had been contracted in euros or Swiss francs) and, in some places, social unrest. While some countries such as Poland and the Czech Republic have resisted the impacts that have befallen nations like Hungary or Latvia, Eastern European countries as a whole have suffered, and they have started to resent what they perceiv as a lack of solidarity from larger Western member states. The former Hungarian Prime Minister spoke about a "new iron curtain" during the March 1st EU summit, while Robert Zoellick, the president of the World Bank, warned that Europe risked erasing the political gains made during the last 20 years. As will be mentioned below, some steps have been taken to address this situation.

Still, one doomsday scenario lies in the possible collapse of an Eastern country, which would not only have damaging economic consequences for Western banks but, more importantly, would lead to a political backlash against the EU in the region. (A collapse of Ukraine would also send shock waves, although less politically damaging, throughout the region). An added danger could be a Russia that seeks to exploit the opportunity to increase its influence in the region by bailing out Eastern European countries with better terms than the EU or the IMF. Moscow has reportedly set aside $7.5 billion for this task[12]. If the crisis drags on over the next years, a less spectacular, but more likely outcome is the gradual impoverishment of Eastern Europe, accompanied by rising bitterness and resentment vis-à-vis Western Europe – a slow estrangement from the common destiny and an incremental erosion of the European dream in the hearts and minds of Eastern Europeans.

e) A centrifugal political process leading to soft partition

It is a comparably slow process of drifting apart which could prove the most threatening to Europe at its core. In the fall of 2008, we witnessed strikingly different responses by the UK, France and Germany to the crisis. The British stimulus focused on boosting demand, the French plan on strengthening supply, and the Germans, at first, didn't want any stimulus package whatsoever. These divergent strategies may hint at things to come, as the economic crisis continues to exacerbate the differences between national economic cultures and structures – between the financial-centered credit-addicted British economy, the domestic-driven and state-centered French economy, and the export-driven inflation-adverse German economy.

[10] IMF figures quoted by Wolfgang Münchau, op. cit.
[11] Cf. Franck Lirzin, "L'Union européenne face au défi de la crise des pays d'Europe centrale et orientale", Questions d'Europe n°134, http://www.robert-schuman.org/question_europe.php?num=qe-134

[12] Tomas Valasek, "Economic crisis and the 'eastern partnership' ", Center for European Reform, March 10, 2009, http://centreforeuropeanreform.blogspot.com/2009/03/economic-crisis-and-eastern-partnership.html

The danger here is to allow these differences to become so significant in policy-making during times of crisis that they become irreconcilable and make economic coordination impossible. With time, that would cause skepticism to creep into all common policies and lead to slackened discipline and adherence, with major countries maintaining rhetorical commitment to European unity while in reality flouting the rules of the game, starting with the Stability and Growth Pact. In the worst-case scenario, if this tendency is met with a lack of leadership and vision and a climate of mutual recrimination, it could lead to something like European deconstruction, or even a "soft partition" of the EU.

2. What doesn't kill the EU makes it stronger: the case for survival and rebound

European disintegration is neither certain nor unimaginable. In spite of Europe's many vulnerabilities, of the striking differences that remain between member states, and of the absence of a strong feeling of common identity among populations, the European construction has deeper roots and a more robust structure than most observers perceive. The case I will argue in the second part of this paper is that the forces and the "logic" of European integration and interdependence are stronger than the centrifugal populist forces, even – and especially – in times of crisis. Indeed, I believe that not only will the EU not break up, but that the tensions generated by the economic downturn will lead to greater European unity, though it may be a modest increase.

Let's start with a few preliminary observations and some good news about the current situation before getting to the core of the argument in favor of a rebound.

Countries want to join, not quit, the EU and the Eurozone

Judging by their popularity, the EU and the Eurozone are not endangered species. Not only is there no discussion among member states about leaving or reducing official commitments (not even euroskepticism, it has been noted, is on the rise), but since the crisis began, even more countries are applying to become part of the club. This is somehow comparable to the fate of the US dollar in the current crisis: whatever their current vulnerabilities, these are institutions that people consider safe, reliable and protective in times of turbulence. So for example, recently elected Prime Minister Johanna Sigurdardottir of Iceland said she hoped to hold a referendum on joining the EU within 18 months, reversing a long-held Icelandic position. And the euro has had a powerful shielding effect for those integrated, as Jean-François Jamet and Franck Lirzin have noted[13]. So it is no wonder that some East European countries want to expedite their accession to the common currency. Poland, for example, discussed possibly speeding up its entry into the Exchange Rate Mechanism – 2 (the antechamber to the Eurozone). Even the debate in the UK has been renewed because of the crisis. Just next door in Ireland, where 53.4% of its voters rejected the Lisbon treaty in a June 2008 referendum, the public seems to have had a change of heart since the economic downturn. Opinion polls on the favorability of the treaty started to reverse in the fall of 2008 and are now stable at around 52-54% in favor of the treaty.

Europe keeps making progress

This paper focuses on the political, rather than purely economic, implications of the crisis for Europe. Its underlying assumption is that the downturn might do more than just economic damage. But the reverse is true as well. Europe's resistance and resilience will partly come from

[13] Jamet, Lirzin, op.cit.

its solidity in other domains, from its overall credibility and image as a political entity in the eyes of Europeans, non-Europeans, and the markets. And in the recent months, in spite of its institutional problems, Europe has scored some notable successes, especially while France held the rotating presidency of the EU[14]. Two of these achievements deserve to be mentioned. On climate change, Europeans approved a far-reaching and binding agreement on a program to drastically reduce CO^2 emissions (the "2020 agenda"), establishing the EU a global leader in efforts to move to a low-carbon economy. On security and stability, Europeans launched the EUNAVFOR Atalanta operation against piracy off the coast of Somalia – the first naval mission in EU history. This mission is significant not only because it is a truly multinational effort and has already made a tangible difference in the region, but also because the operation provides a global public good to all countries while actively defending Europe's own direct economic interests. These two examples show that the economic downturn has not stymied Europe's momentum for other initiatives and confirm that the union is much more than an economic association.

There should not be a unique report card for European institutions

Since the beginning of the crisis Euroskeptics and European enthusiasts alike have had harsh words for EU institutions. They are justified in their criticism of the European Commission, which has performed rather poorly and revealed a number of weaknesses. This is partly the result of a long-term shift in power away from the Commission and towards the Council, but it is also due to José Manuel Barroso's lack of leadership. If major crises offer windows of opportunity not to be wasted, then the Barroso Commission has clearly squandered the chance to enhance its role and to embody European interests. It has failed, for example, to offer more coordination and leadership on stimulus packages and to initiate an EU-wide auto industry bailout. The divided Czech EU presidency has fared only marginally better, requiring urging by Germany and France to take action and organize a special summit to address the economic crisis[15].

There should not be just one scorecard for all European institutions, however, as some have reacted much better to the crisis. A case in point is the European Central Bank (ECB), a relatively young institution with a limited mandate that has managed to retain its full credibility while charting new territory. It aggressively injected liquidities into the market when the crisis started in August 2007 and enacted a 3.25-point interest rate cut between October 2008 and May 2009. It is also finding new flexibility in the tools at its disposal and can increasingly come to the rescue of the European economy. While not engaging in quantitative easing *per se*, something it cannot not do as easily as its American and British counterparts (among other restrictions, the ECB cannot buy state debt), it is currently implementing non-conventional policies, such as asset purchases (intervening directly in the market for corporate debt)[16] and the purchase of 60bn euros in covered bonds (bonds secured by mortgage pools or public debt) as a further measure to promote lending[17]. It is also "extending the maturity of its basic refinancing operations — in normal times a weekly event — to 12 months," thereby substituting itself to the

[14] See Federiga Bindi, Charles Kupchan, Justin Vaisse, "Sarkozy's Europe is Good for Obama," *International Herald Tribune*, January 14, 2009.

[15] Cf. Jean Quatremer, "Prague contraint de convoquer un sommet européen extraordinaire", *Coulisses de Bruxelles blog*, February 9, 2009, http://bruxelles.blogs.liberation.fr/coulisses/2009/02/prague-contraint-de-convoquer-un-sommet-europ%C3%A9en-extraordinaire.html

[16] Ralph Atkins, "ECB ready to put policy tools to work", *Financial Times*, April 30, 2009.

[17] Carter Dougherty and Julia Werdigier, "Central Banks in Europe Ease Credit Policies Further", *International Herald Tribune*, May 7, 2009.

faltering inter-bank lending and injecting liquidities in the European financial system[18].

Interestingly, other lesser known European institutions have also been able to help with the crisis, such as the European Bank for Reconstruction and Development and the European Investment Bank. The latter has increased its capital by 67bn euros, bringing it to 232.4bn, in order to rapidly expand its lending volume as part of anti-crisis measures. In other words, some leaner EU institutions are finding greater flexibility in their mandates and responding constructively and creatively to the downturn.

The system is working – even if it's hurting

The idea of issuing joint EU bonds, or EU-backed government debt, as suggested by several well-known personalities like Eurogroup President Jean-Claude Juncker, could have been mentioned in the previous section on the flexibility and responsiveness of some EU institutions.[19] The objective of such EU bonds, of course, would be to ease the impact of the bonds spread on weaker countries by providing them with cheaper credit to respond to the crisis. States like Germany and the Netherlands, however, are protesting the idea, as it would make it more costly for them to borrow jointly with Greece, Spain, Ireland and others.

So the question begs, is this a failure – a sign of the inflexibility of EU institutions, or is it a healthy and corrective adjustment enforced by the system? After all, there is no reason why economically stable countries should pay the same interest rate as more irresponsible ones, since the former carry much less risk than the latter. And if the latter don't pay a price for their undisciplined budgetary behavior, then incentives for good governance in the EU are undercut. The same could be said of the "no bailout clause" and the interdiction to the ECB to buy state debt. These restrictions may be painful for some countries and may be challenged by some critics as an insult to solidarity, but they ensure that the riskier countries don't indulge in policies that would be detrimental to the EU as a whole.

A similar phenomenon could occur in the political and institutional sphere. Take the lack of coordination on stimulus packages, or the dispute over the auto industry bailout. The "European system" worked somewhat, in the sense that German, Spanish and, perhaps more importantly, even French auto bailouts were closely examined and then approved by the European Commission, after it was determined that the common market was not at risk. But, the fact that countries had to go it alone with neither the Commission nor the Czech presidency taking the initiative to coordinate a pan-European bailout constituted a noticeable disappointment for supporters of a more decisive EU. The optimistic take on this, however, is that these perceived missteps may prove to be just the right spur towards achieving the first real steps of adaptation, innovation and closer unity of action. Precisely because the levels of attention and alert were elevated, the Commission and the Council were harshly criticized, and the people concluded more Europe was necessary, we may in fact see greater appreciation of the issue next time and a better, more comprehensive response.

But let's get beyond these general observations and examine now the three main reasons why Europe could not only survive, but also be reinforced by the crisis.

[18] Op. cit.

[19] Cf. Euractiv.com, "Almunia backs EU bonds, has eurozone bailout plan", Euractiv.com, March 4, 2009.

a) The logic of integration: "too interdependent to fail"

The central argument against the break-up hypothesis is the profound interdependence created by the European construction that makes partitioning (even soft partition) or deconstruction extraordinarily costly. It similarly makes it very difficult for large states to just let a weaker member of the Eurozone or the EU collapse. In other words, Europe will survive, and could even get a bounce, not out virtue and courageous leadership – which have been sorely lacking so far – but out of necessity and fear. Pressed by restive public opinions, policy makers could contemplate unilateral and beggar-thy-neighbor options, but their cost is likely to remain considerably higher than the pursuit of European unity for some time to come. Take the example of Eastern Europe. In times of growth, there was dynamism between old countries and new countries, between "givers" and "takers" – new markets for the former, sustained investment and development for the latter. This created a deep economic interdependence which makes it impossible now for major economies in the West to cut their Eastern counterparts loose for fear of seeing their banks and corporations take a sizeable hit and their stability – and Europe's as a whole – threatened.

There have already been concrete signs of response. In spite of complaints about lack of solidarity for Eastern European member states, the EU twice doubled its macro-economic support for EU members outside the eurozone, from 15 to 25bn euros and from to 25 to 50bn euros.[20] IMF lending has been boosted, thanks in part to West Europeans, and this benefits the East. "Out of the 20 programs launched since last summer, 11 are for countries in the region", wrote Stefan Wagstyl of the *Financial Times* at the end of April. The European Union is also contributing, notably with aid for crisis-hit member states such as Latvia."[21] And what about countries inside the eurozone which could default on their debt, such as Greece or Ireland? The tradition here is the "no bailout clause", intended to avoid moral hazard. But faced with such a severe crisis, Germany stepped in. In February 2009, Peer Steinbrück, the German Finance Minister, declared "The euro-region treaties don't foresee any help for insolvent countries, but in reality the other states would have to rescue those running into difficulty."[22] This "solidarity clause", which now coexists with the "no bailout clause", was reaffirmed by Joaquin Almunia, the monetary affairs commissioner, shortly afterwards: "If a crisis emerges in one eurozone country, there is a solution before visiting the IMF. It's not clever to tell you in public the solution. But the solution exists."[23] What this implicit reassurance means is that large states like Germany would not let other eurozone countries go bankrupt, even if it would be politically very costly for them to prevent the bankruptcy. This is a significant new step towards a more integrated Europe.

b) Other powerful counter-forces to the rescue

Before it is forced to react to the impending failure of a member state, the EU can rely on several political counter-forces to avoid "European deconstruction": the market, elite opinion and peer pressure.

Economic interdependence between member states has rendered protectionist measures – including stealth protectionism – largely self-defeating. Nicolas Sarkozy's declaration on the localization of auto industries, for example, was

[20] Euractiv.com, "EU secures €50bn to bail out new members", March 20 2009.

[21] Stefan Wagstyl, "Poland's credit line is a shot in the arm for Eastern Europe," *Financial Times*, April 27, 2009.

[22] Bertrand Benoit, Tony Barber, "Germany ready to support eurozone action", *Financial Times*, February 19, 2009.

[23] Quoted by Tony Barber, "Emergency eurozone aid signaled," *Financial Times*, March 3 2009.

met by a retaliatory threat from Slovakia to shut its promising market to Gaz de France. More importantly, industries themselves have reacted negatively. The head of the French carmaker Peugeot pointedly insisted that his Czech plant would stay open while 3,000 jobs in France would go, and Volvo (which owns Renault Trucks) preemptively announced it would refuse proposed state aid in order to retain its freedom in deciding where to locate activities. Ironically, European inter-dependence is so extensive that even protectionist-minded measures end up benefitting other countries. Auto bailouts in the large Western countries, for example, ensure that Eastern European factories remain open. And car-scrapping schemes, intended to boost demand in the West, has exactly the same beneficial effect on Eastern plants.

One of the most worrying scenarios for Europe would be one in which populist and nationalistic policies spread from one country to the other, leading to the slow demise of the EU. But before this could happen, there are various layers of resistance that must first be overcome, starting with the very powerful common ideology that binds Europeans together. Elites and public opinions can argue about the optimal institutions and policies for Europe, its degree of federalism v. national sovereignty, etc., -- but Europe remains the horizon of all political and economic debates. There simply are no credible forces at this point offering an alternative to policies made inside the European framework – no standard-bearer, except for old ones (like British euroskeptics, to some extent), for a policy of going it alone or going backwards on integration. In other words, taking steps that would undermine "the common house" is still a taboo.

This leads us to the third counter-force against the disintegrating effects of the crisis, "peer pressure" among policy makers and elites. Not only is Europe bound by a powerful common ideology, but there is also a constant surveillance and consideration of each member state's every move. Instantaneous and, if necessary, substantial pressure can be applied by members on one another in order to preserve the common market and the European construction. Outside observers might be forgiven if they thought that Europe was on the brink of collapse during the Fall of 2008 and the winter of 2009, so loud were the cries and criticism against any action even remotely considered threatening to the EU. Angela Merkel and Nicolas Sarkozy, respectively on the issue of the stimulus and the auto bailout, triggered considerable disapproval, even though their initiatives presented little actual danger to Europe. But that over-reaction was a testimony to the vigilance of pro-European forces.

c) Institutions and leadership: the worst is not always certain

There is no doubt that European leaders have not been very impressive since the beginning of the crisis. While the case made here, that Europe will weather the crisis, relies not on leadership but on structural factors, it cannot be ruled out that in later stages of the downturn, major European figures and institutions may get their act together and effectively take charge. This transformation could come as early as the second part of this year, and it is perhaps even easier to imagine a number of optimistic scenarios where this plays out than the dire forecasts described earlier.

First, a more decisive European Commission under a new leader might emerge, one that won't "waste the crisis" a second time and takes advantage of the situation to offer greater leadership and coordination. The Lisbon treaty may be finally ratified (largely thanks to the crisis, and the fear it incites), which puts institutional questions aside for the first time in a decade, slightly improves EU governance, and markedly improves the climate for European policy-making. A more decisive European Council, whether in the form of the new permanent President or a good working relationship between the permanent head and the country holding the rotating presidency, could initiate a pan-EU second stimulus and a coordinated bank bailout.

Very sensible words have already been heard from Spain, where José Luis Zapatero is priming to assume the rotating presidency of the EU in the first half of 2010. "I agreed with President Sarkozy that if the European Union really wants to be a political union, which works for its citizens, it has to have a much more solid economic government [...] with tools," Zapatero told journalists in Madrid. "I can't see a single market, a single currency, then not see an economic government with powers," he added[24]. Maybe Zapatero, along with a new European Commission and a permanent president, will have a chance to write the famous "second act" of Europe's response to crisis – one where, after staring at the abyss and visiting all the most unpalatable options, the EU finally rebounds to reach a new stage of its development.

CONCLUSION

Even short of this rosy scenario, it is unlikely to see Europe break up because of the downturn, while it is quite possible we will witness at least some progress in response to the crisis – even if, and maybe especially if, this crisis becomes more threatening. After all, the EU finds itself in the same predicament as all other governing bodies worldwide: the economy has globalized at an accelerated pace while most policy tools are still national. This is especially true for the financial world: "Our current national framework for financial regulation is incapable of governing a global financial system," concludes the *Financial Times* upon assessing the future of capitalism[25]. But the difference for Europe is that it offers much greater and more attainable potential for a coordinated response to the crisis than a worldwide government which would be necessary to meet the challenge of the current economy. It doesn't mean that European leaders will be able to seize that opportunity, but it means that they already have a formidable instrument to better protect their citizens, improve the situation of the economy and impose better rules of worldwide governance – if only they decide to put it to work.

[24] Euractiv.com, "Spain to push economic integration at EU helm", April 29, 2009.
[25] *Financial Times* editorial, "Lessons learnt for capitalism's future", April 13, 2009.

ABOUT CUSE:

Europe is currently undergoing a profound transformation in terms of its leadership, the composition of its population, the expansion of memberships in the European Union and NATO, changing relations with key countries like France, Turkey, and Russia, and a regained willingness to address global challenges. In April 2004, Brookings launched the Center on the United States and Europe (CUSE) to understand these challenges and their relevance to U.S. foreign policy. The Center offers an ongoing forum for research, high-level dialogue, and public debate on issues affecting U.S.-Europe relations.

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