

## What if Europe Fails?

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The European Union is engaged in a ferocious political, diplomatic, and economic struggle to preserve the future of the single currency, the Euro, and the viability of what has become known simply as “the project,” namely the process of integration that has been the bedrock of Western European politics for over half a century. It is distinctly possible that its members’ efforts may fail, either in the short or long term, and give way to an era of disintegration. Some have sounded the alarm: German Chancellor Angela Merkel famously remarked, “If the Euro fails, Europe fails.”<sup>1</sup> Former president Nicolas Sarkozy of France predicted, “If the euro explodes, Europe would explode. It’s the guarantee of peace in a continent where there were terrible wars.”<sup>2</sup> Polish Foreign Minister Radek Sikorski warned the Euro’s collapse could cause an “apocalyptic” crisis.<sup>3</sup> Harvard economist Dani Rodrik cautioned “the nightmare scenario would . . . be a 1930’s-style victory for political extremism.” After all, “fascism, Nazism, and communism were children of a backlash against globalization.”<sup>4</sup> The erosion of democracy in Hungary and the rise in support for populist parties in Greece, the Netherlands, Finland, and France appears to some to be the beginning of the end.

Yet, verbal warnings from nervous leaders and economists aside, there has been remarkably little analysis of what the end of European integration might mean for Europe and the rest of the world. This article does not predict that failure will occur—it only seeks to explain the geopolitical implications if it does. The severity and trajectory of the crisis since 2008 suggest that failure is a high-impact event with a non-trivial probability. It may not occur, but it certainly merits serious analysis. Failure is widely seen as an imminent danger,

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but even if this moment passes, it will remain a significant risk for some time to come.

Would the failure of the Euro really mean the beginning of the end of democracy in Europe? Could the global economy survive without a vibrant European economy? What would European architecture look like after the end of European integration? What are the implications for the United States, China, and the Middle East? Since the international order has been primarily a Western construction, with Europe as a key pillar, would the disintegration of the European Union or the Eurozone have lasting and deleterious effects on world politics in the coming decade?

Thinking through and prioritizing the consequences of a failed Europe yield five of the utmost importance. First, the most immediate casualty of the failure of the European project would be the global economy. A disorderly collapse (as opposed to an orderly failure, which will be explained shortly) would probably trigger a new depression and could lead to the unraveling of economic integration as countries introduce protectionist measures to limit the contagion effects of a collapse. Bare survival would drag down Europe's economy and would generate increasing and dangerous levels of volatility in the international economic order.

Second, the geopolitical consequences of an economic crisis depend not just on the severity of the crisis but also the geopolitical climate in which it occurs. Europe's geopolitical climate is as healthy as can be reasonably expected. This would prevent a simple repeat of the 1930s in Europe, which has been one of the more alarming predictions from some observers, although certain new and fragile democracies in Europe might come under pressure.

Third, failure would cement Germany's rise as the leading country in Europe and as an indispensable hub in the European Union and Eurozone, if they continue to exist, but anti-Germanism would become a more potent force in politics on the European periphery.

Fourth, economic downturn as a result of disintegration would undermine political authority in those parts of the world where the legitimacy of governments is shallow, and it would exacerbate international tensions where the geopolitical climate is relatively malign. The places most at risk are the Middle East and China.

Fifth, disintegration would weaken Europe on the world stage—it would severely damage the transatlantic alliance, both by sapping its resources and by diverting Europe's attention to its internal crisis—and would, finally, undermine the multilateral order.

Taking these five implications in their totality, one thing is clear. Failure will badly damage Europe and the international order, but some types of failure—most notably a disorderly collapse—are worse than others. Currently,

the pain is concentrated on the so-called European periphery (Greece, Portugal, Spain, Italy, and Ireland). Disorderly collapse would affect all European countries, as well as North America and East Asia. If a solution to the Eurocrisis is perceived as beyond reach, leaders of the major powers will shift their priorities to managing failure in order to contain its effects. This will be strenuously resisted on the periphery, which is already experiencing extremely high levels of pain and does not want to accept the permanence of the status quo. Consequently, their electorates will become more risk-acceptant and will pressure Germany and other core member states to accommodate them through financial transfers and assistance in exchange for not deliberately triggering a break-up. This bitter split will divide and largely define a failing Europe. Absent movement toward a solution, EU politics is about to take an ugly turn.

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### **How Failure Could Occur**

A framework can help us understand the geopolitical implications if the Euro and/or the European Union fail. As conceptualized here, failure could take two forms. The first is a form of failure which allows the Eurozone and the European Union to barely survive—under conditions of low growth, high unemployment, and social unrest—not because the member states continue to believe in the project but because they cannot figure out how to extract themselves at an acceptable price. The second is a failure that leads to the disorderly collapse of the Euro and/or the European Union.

There is, of course, a third scenario—success. I deliberately avoid this scenario in order to comprehensively explore the consequences of failure. However, success is also far from assured for several reasons—the EU response is defined by Germany and has little prospect of restoring growth on the periphery; nationalism is a powerful and growing force which will complicate moves to the creation of a United States of Europe; and serious fault lines remain, which means the Eurozone will be crisis-prone for some time to come. As a senior German official told the *Financial Times*, “It seems to me that we have invented a machine from hell that we cannot turn off.”<sup>5</sup>

The Eurocrisis resulted from the creation of a monetary union absent a political and financial union. This arrangement facilitated cheap supplies of money to the periphery in the Euro’s first decade and left the debt (both public and private) in the hands of each member state after the 2008 crisis. The states worst affected (Greece, Portugal, Ireland, Spain, and Italy) are each unique, but all face rising borrowing costs and are unable to devalue their currency to become

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more competitive. The crisis negotiations have focused on ways to put the peripheral economies on a sustainable path (through competitiveness reforms) and to address the causes of the crisis. The country-specific plans have failed to have the desired affect because the austerity measures introduced have depressed growth and deepened the recession. Some progress appears to have

been made at the Eurozone's summit in June 2012, particularly in banking and sovereign bond purchases but many problems were left unaddressed.

The dominant view among experts is that the crisis can only be solved if the Eurozone moves toward full fiscal, financial, and political union, where all of the key decisions about tax and expenditure would be taken at the European level. However, the political climate is extremely hostile to ambitious plans of this nature. The periphery will not be inclined to buy into an indefinite austerity program and to trust Germany to protect their interests. And the core has serious misgivings about sacrificing fiscal sovereignty and underwriting the periphery. Much existing analysis assumes that political hurdles can be overcome, largely because a failed Europe is deemed unthinkable. Yet, failure is a regular occurrence in world affairs—one need only look at the way the politics of tackling climate change evolved in the 2000s. As a purely analytical matter, it is prudent to allow for the possibility that political hurdles will not be overcome because they are truly insurmountable.

The absence of a solution is a necessary but insufficient condition for true failure. There are at least four accidents or triggers that could precipitate an inadvertent unraveling, and failure, in Europe.

- *The Eurozone reforms are implemented but fail.* This would lead to the first scenario of failure—bare survival. Austerity without end leads to low to non-existent growth, exacerbated regional tensions, and an end to further integration. Most member states would gladly leave if only they could find a way to do so with acceptable economic costs.
- *Europe's plan is rejected at a national level leading to fragmentation.* The national political barriers to treaty changes or a major and permanent sacrifice of sovereignty are considerable and include referendums, parliamentary supermajorities, and the support of constitutional courts. Some countries may fail to ratify the reforms or withdraw from them later. Depending upon the precise circumstances, they may be forced to leave the Euro, they may judge the costs of exit to be less than the current costs of staying in, or they could be excluded from formal governance structures.

- *The Eurozone incorrectly calculates it can survive a pruning.* Throughout the crisis, experts and some political leaders have speculated that the Eurozone could survive, and may even benefit from, losing one or two of its weaker members such as Greece. The logic is fairly straightforward: a smaller, more cohesive group of strong economies would lack the structural flaws of a larger, more diverse Eurozone. The new Eurozone could absorb the contagion brought about by the exit of a small economy, although probably not a large state like Italy. This may be true, but as the world learned with Lehman Brothers, there is no way of knowing for sure. Pruning could set in motion a series of events resulting in mass defaults and the collapse of the Euro.
- *Economic shock to the system.* Europe's leaders may wish to avoid the breakup of the single currency, but the Eurozone remains vulnerable to a sudden and destabilizing crisis that triggers a breakup. This shock could take the form of a contagion following default or a bondholder haircut from a peripheral country, the collapse of one or more of Europe's largest banks, or the collapse of the Euro swap market.<sup>6</sup> Any of these events could cause contagion throughout the Eurozone and overwhelm the European Union's capacity to bail out member states. By their very nature, the timing and scale of an external shock are hard to predict.

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Failure of the European project could occur under any of these scenarios, but what might happen if it does?

## **The Global Economy Imperiled**

The most immediate and obvious impact would be on the European and global economy. The two scenarios under consideration are bad, but one is much worse than the other. It is the overwhelming view of senior economists, financial institutions, and international organizations that the *disorderly* collapse of the Eurozone, resulting in a return to national currencies, has a high probability of causing a new depression and ending the period of economic integration which has characterized world politics since the Cold War. For instance, the OECD's Economic Outlook in November 2011 warned:

The establishment and likely large exchange rate changes of the new national currencies could imply large losses for debt and asset holders, including banks that could become insolvent. Such turbulence in Europe, with the massive wealth destruction, bankruptcies and a collapse in confidence in European integration and

cooperation, would most likely result in a deep depression in both the exiting and remaining euro area countries as well as in the world economy.<sup>7</sup>

In the private sector, Citi's chief economist William Buiter wrote that disorderly defaults and eurozone exits by the five periphery states—Greece, Ireland, Portugal, Spain, and Italy—would

drag down not just the European banking system but also the north Atlantic financial system and the internationally exposed parts of the rest of the global banking system. The resulting financial crisis would trigger a global depression that would last for years, with GDP likely falling by more than 10 per cent and unemployment in the West reaching 20 per cent or more. Emerging markets would be dragged down too.<sup>8</sup>

Other analysts have reached similar conclusions about the consequences of a Euro break up. HSBC predicted, "A euro break-up would be a disaster, threatening another Great Depression;" UBS estimated that a breakup would cost each peripheral economy up to 40 percent of their GDP in year one; ING estimated that the Eurozone as a whole (including Germany) could see a 9 percent drop in the first year following break up, while inflation in the periphery would soar to double digits; IMF chief Christine Lagarde warned that the global economy faces the prospect of "economic retraction, rising protectionism, isolation and . . . what happened in the 30s."<sup>9</sup>

Following a disorderly breakup, it is highly likely that it would be every state for itself as governments sought to do everything possible to insulate their countries against the greatest economic shock in the West since World War II. A return to national currencies would result in tremendous fluctuations, uncertainty, and volatility following redenomination, including a redenomination of complex international contracts.<sup>10</sup> It would also mean that countries with a weak currency would immediately be bankrupt, as their assets would have depreciated while their debts would be denominated in the currency of the creditor state. These states would introduce capital controls to prevent capital flight and the collapse in value of the new currencies. Strong states would introduce tariffs to protect against competitive devaluations and cheap imports. The European single market would not likely survive. Globally, governments would try to save what they could and would likely replicate some of the protectionist measures introduced in Europe. The net effect could jeopardize global economic integration and open the door to neo-mercantilism and protectionism.

In a bare survival scenario, the Eurozone muddles through intact but never properly addresses the root causes of the crisis. Sovereign debt continues to be costly and peripheral states are forced into new bailouts or some form of default. As economists Simon Johnson and Peter Boone put it, "At the least, we expect several more sovereign defaults and multiple crises to plague Europe in the next few years. There is simply too much debt, and adjustment programs are too slow

to prevent it.”<sup>11</sup> Widespread austerity would suppress demand and cause a deep and prolonged recession with low growth and high unemployment. Europe’s problems would fester in the markets and prevent confidence from returning. Berkeley University economist Barry Eichengreen has argued, “If Europe fails to grow, it will not be able to dig its way out of its debt hole and restore the confidence necessary for the euro to remain a significant source of international liquidity.”<sup>12</sup> The destruction of the European growth engine would drag down international trade, damaging both the United States and China, although U.S. borrowing costs are likely to remain low as it stays a safe haven for capital. The overall picture from a Europe barely hanging on is one of a lost decade.

The consequences of a lost European decade are quite different than that of a disorderly collapse. The rest of the world would suffer because of reduced European demand and investment but they would be spared the great shock that could result from a disorderly breakup. The bulk of the economic costs would be borne by Europeans themselves. The absence of the shock of a depression means that governments would not be forced into a protectionist or mercantilist policy. They would have some choice in the matter and as Adam Posen, an external member of the Monetary Policy Committee of the Bank of England, has argued, they would choose to keep the global economy relatively open.<sup>13</sup> The emerging powers have benefited greatly from the global economy and have even seen their positions improve during the crisis. They have no incentive to pull up the drawbridge. On the other hand, the West’s leadership would continue to support the open global economy for geopolitical as well as economic reasons, even though the benefits would be less obvious than they were in the past. There would be populist backlashes in the West, but actions taken are unlikely to pose an existential threat to openness. However, Posen also astutely observes that the continuation of economic integration would take a very different form after the crisis. The decline of Europe means that it would be much harder to manage globalization.<sup>14</sup> The world would come closer to unfettered markets as international governance structures are weakened. It would be a volatile environment and prone to populism, imperial competition for resources, and economic crisis.

**The decline of Europe means that it would be much harder to manage globalization.**

In sum, Europe’s failure would hit the global economy hardest. The worst-case scenario could plunge the world into a new depression and the end of a long period of global economic integration. The more benign scenario would drag down global growth but have the opposite effect on the general direction of the economic order—continued economic integration, including the free movement

of capital, but in a way that is increasingly unmanageable as well as unfettered, introducing dangerous levels of volatility into the economic cycle.

## Don't Expect a Return to the 1930s

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**The full effect of an economic order's collapse depends upon the geopolitical climate.**

The contemporary international economic order is in a state of crisis, which may be akin to the crisis of the interwar economic order from 1929–1932. We have yet to see if the crisis deepens even further, as it did then, but the early stages have been similar.<sup>15</sup> However, the effect of an economic order's collapse depends upon the geopolitical climate in which it occurs. The 1930s was a particularly harsh, vulnerable, and unforgiving period. Odd as it seems, it is our great fortune that the current once-a-century economic

crisis takes place in a much more benign geopolitical environment, at least as far as Europe is concerned. Europe has invaluable antibodies today which would slow the effects of any political cancer stemming from a second great depression.

Fortunately, European politics today is not dominated by ideological competition between the extremes. Voters do not have to choose one evil over another. Western Europe has enjoyed over half a century of stable liberal democracy, widely perceived as the only legitimate means of government. No major party calls openly for a new authoritarian system of government, although it is important to add the caveat that some small extremist parties, such as the Greek Nazi party Golden Dawn, do seek to overthrow democracy (they have been condemned and isolated by the rest of the Greek political system). Europe has long struggled with a “democratic deficit,” whereby technocratic elites operate without a popular mandate, but it is not remotely comparable in scale to the legitimacy crisis of the early 1930s or even the 1920s. The strength of democracy means fringe parties have a far higher mountain to climb.

The Great Depression led to Europe's apocalypse, at least in part, because the basis of the post-World War I order, the Treaty of Versailles, was generally regarded by Germans as punitive and unjust. Thankfully, there is no European geopolitical grievance remotely comparable to Versailles. The European Union is a security community where war between its member states is unthinkable and unplanned for. By contrast with the interwar period, Europe's fringe parties appeal to domestic issues rather than rearmament and a more assertive foreign policy. Even if the European Union fell apart, one could safely assume that Europe's leaders would still make strenuous efforts to preserve the peace.



The U.S. commitment through NATO also has a positive pacifying effect. In a greater Europe, only Russia would like to revise the order in its favor. Yet, Moscow has significant constraints preventing its resurgence, including a weak economy, demographic trends, and NATO's enlargement.

The geopolitical state of Europe today is about as healthy as one could reasonably expect when viewed in a historical context. If the geopolitical path mirrored that of the economy, the future would indeed be bleak. Fortunately, it provides a buffer against a repeat of Europe's most tragic episode. Yet, there is still cause for concern. Europe may not be about to return to the 1930s, but the failure of the European project would still be extremely damaging by most other metrics. A growing number of governments would be influenced by populist and nationalist sentiment. In creditor countries, such as Finland and Holland, populist parties would have a powerful message about being put on the hook for the perceived folly of debtor nations. In debtor countries, such as Greece, Ireland, and Portugal, populism is directed against the perceived unfairness of the bailouts and the imposition of austerity by the European Union. Both scenarios entail continued austerity in many parts of Europe, core and periphery. In a recent paper, Jacopo Ponticelli and Hans-Joachim Voth conducted cross-country research for the period 1919 to the present day and found that austerity has tended to go hand-in-hand with politically-motivated violence and social instability.<sup>16</sup> Rising populism and nationalism would inhibit regional cooperation and make beggar-thy-neighbor policies much more likely.

In some exceptional cases, democracy could be at risk. The canary in the coal mine may be Hungary, which has come under intense criticism for Prime Minister Viktor Orban's efforts to consolidate his party's hold on power. Orban used his large majority in parliament, won after his predecessor was discredited by the collapse of the Hungarian economy and the intervention of the IMF in 2008, to rewrite the constitution. The new rules reduced the independence of the judiciary and the central bank, and revised electoral laws in favor of the governing party, raising concern throughout Europe and in the United States. Greece is another obvious concern—the shock of a complete collapse of the Greek economy could lead to widespread social unrest, some violence, the further empowerment of populist parties, and an increase in support for extremist and xenophobic parties such as Golden Dawn.

Finally, if the Eurozone and the European Union survive, it may be in name only. Genuine cooperation would be hard to sustain under the glare of skeptical and engaged domestic audiences. What is agreed in an intergovernmental setting may fall apart in national parliaments. Large states would use all the leverage they could muster to advance their national interests, usually narrowly defined.

In sum, European democracy should easily weather the storm of a failure of integration, although there may be one or two exceptions. Yet, that is not to say that European politics would not take a turn for the worse in some important respects.

## **The Centrality of Germany and the Rise of Anti-Germanism**

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The great geopolitical irony of the Eurocrisis is that while monetary union was originally designed to constrain German influence in the European Union, it created the crisis that led to the growth of Germany's relative power and much more assertive German leadership, at least in the area of political economy. After the Cold War, France insisted upon monetary union as the quid pro quo for German reunification. Germany agreed, judging it consistent with its postwar goal of avoiding the isolation of Germany in Europe by Europeanizing Germany instead of Germanizing Europe. Now, while no German politician deliberately seeks isolation, Germany appears to have decided that the only way to save the European Union, and to prevent it from becoming what Merkel called "a sort of partial museum," is by Germanizing it.<sup>17</sup> This entails persuading the other member states to reform their economies so they become more like Germany, or at least so their economic policies are heavily influenced by Berlin.

This shift appears to be in line with public opinion. A poll conducted by the Allensbach Institute in January 2011 found that more than 50 percent of Germans have little to no faith in the European Union, and over 70 percent do not see Europe as the future of Germany.<sup>18</sup> Germany remains a country heavily socialized to the norms advanced by the European Union, but it is beginning to spread its wings a little more than it used to. In Oxford scholar's Timothy Garton Ash's clever turn of phrase, we are now en route to "a European Germany in a German Europe."<sup>19</sup>

Another Briton, Charles Grant of the Center on European Reform, has observed that the crisis means "Germany is the unquestioned leader for the first time in the history of the EU. But whether it knows how to lead is a different matter entirely. Many Germans are uncomfortable with the role."<sup>20</sup> This may be why Germany has framed the policy choices available in the Eurocrisis as a Lutheran morality tale between responsible austerity and irresponsible profligacy, rather than as a clash of equally legitimate interests. In this telling, Germans are innocent bystanders forced to grapple with the mistakes of others. Framing the crisis as a morality tale means that Germany is not merely advancing its own interests, but is pursuing the right choice for the Eurozone as a whole. It is the element of righteousness that has enabled Germany to cast aside the restraints which would have remained in place if its foreign economic policy were to be conceptualized as driven by national interest alone. As long as Germans think of

their policy choice as the morally correct path, they will find it easier to overcome the historical psychological barriers to pursuing an assertive foreign economic policy.

There is abundant evidence of Germany's assertiveness in foreign economic policy during the past two years. Merkel's government has won argument after argument against other member states, often against strenuous objections and deep reservations. Examples

include the continent-wide adoption of austerity economics, the hawkish and inflation-focused approach of the European Central Bank (ECB), the imposition of ECB bailouts on Ireland and Portugal, and the strict conditionality attached to those arrangements. Germany has also proposed structural changes to European treaties, law, and procedures which would strengthen its influence. The German Chancellor made this clear in her November 2010 Bruges speech, in which she criticized the influence and role of the European Commission and European Parliament—the so-called “community method”—and argued in favor of the “Union method”—or what former German foreign minister Joschka Fischer has called the “national primacy” approach—where governments in the European Council make the key decisions.<sup>21</sup> The European Council gives the advantage to the large member states, whereas the Commission is seen as the protector of the small states. Subsequently, the EU Commission, which has hitherto been in the ascendant, dramatically declined in influence relative to the Council. Merkel has also insisted upon formal treaty changes to compel member states to adhere to German budgetary practices. It is important to add the caveat that the June 2012 summit saw Germany suffer its first major political defeat when Italy and Spain used their leverage to exact concessions on banking recapitalization and sovereign bond purchases. However, it was just one step, which could yet fail to materialize. On much else, Germany's views continue to hold sway.

Germany has been able to win most of these arguments because it is the wealthiest member of the Eurozone, the least economically affected by the downturn, and the indispensable partner of all other member states. Amidst the storm, it stands as a safe haven. In January 2012, an auction of six-month German government bills produced a negative interest rate of minus 0.01 percent.<sup>22</sup> In effect, investors were paying to loan money to Germany. In 2011, German exports reached record levels of over €1 trillion while the unemployment rate was Germany's lowest since 1993.<sup>23</sup> Europe may be in crisis, but so far Germans experience it in the abstract, not in their pocketbooks. Although Germany has benefited from Euro membership and would suffer if it

**G**ermans think of their policy choice as the morally correct path, enabling their assertiveness.

collapsed, it is the only member state that can be reasonably confident of a sound currency in a post-Euro environment. Diplomatically, Germany is also the indispensable partner. As European Council on Foreign Relations' scholars Ulrike Guerot and Mark Leonard have noted, as German power has increased, mini-lateral coalitions are increasingly forming around Germany as other member states choose to accommodate German power and, in doing so, attempt to ensure it is used to their benefit."<sup>24</sup>

In the benign scenario of bare survival, the experience of the past two years would likely continue and accelerate. In a continuing economic crisis, Germany would remain the indispensable power, a necessary partner for those who hope to survive. With its own money and future on the line, Germany would strike a hard bargain, extending its reach inside the bureaucracies of other states to ensure they adhere to their commitments, even if they were made under economic duress and asymmetric conditions.

A worst-case scenario of disorderly collapse is more difficult to comprehend, as it could result in the destruction of the continent's institutional architecture. In narrow economic terms, Germany would be damaged by a collapse of the European Union, especially by the appreciation of its new currency and the collapse in demand in its export markets, but it would also be best positioned relative to other member states. It is highly likely that it would pursue a unilateral economic policy to stabilize its economy, regardless of the impact upon the rest of the Union. Politically, the collapse of the European Union would be a calamity for Germany, wrecking its chief postwar foreign policy objective. The notion that they had no choice and were the victims of the mistakes of others might cushion the psychological blow. Geopolitically, Germany would have to adjust to a regional system without an effective economic and political multilateral architecture, where it is the leading power that develops bilateral relations with others. It may try to reconstitute a smaller core community, including France and its immediate western neighbors. Globally, it would become the most important European power as the United States and China come to grips with the changing landscape.

The great risk with the moral frame for German foreign economic policy, which would arise in either scenario, is that it is likely to aggravate other nations who see it as a sanctimonious and insincere power play. Moreover, while Germany's neighbors accept the need for German leadership to find a way out of the crisis, they are unlikely to accept German economic hegemony indefinitely, especially since German perceptions of what other countries should do diverges significantly from how the populations of those countries see it. The measures that the European Union has taken to address the crisis promise to exacerbate the democratic deficit in the Union. The main beneficiary of this shift in power

from other member states is already perceived to be Germany, rather than a truly representative or equitable EU institution.

The past two years have already seen a noticeable increase in anti-German feeling in the peripheral countries. In Greece, the use of Nazi imagery to protest German proposals is widespread.<sup>25</sup> The structural pressures which increase anti-German sentiment are abetted by unfortunate but inevitable misunderstandings which are immediately disseminated through the media. For instance, in September 2010, German EU Energy Commissioner Günther Oettinger suggested that EU officials take over tax collection in Greece so they could “operate without concern for resistance.” He also said that “deficit sinners” be made to fly their flags at half-mast as a symbolic “deterrent” to others.<sup>26</sup> Comments like these are usually frivolous, isolated, and accidental, but they are not always perceived as such and can fan the flames of nationalism and populism.

Anti-German sentiment will continue and increase, particularly if Germany is seen to do relatively well while the rest of the European Union sees their economies deteriorate. In January 2012, Mario Monti, the technocrat who became prime minister of Italy after the fall of Silvio Berlusconi, told the German newspaper *Die Welt*, “I am demanding heavy sacrifices from Italians. I can only do this if concrete advantages become visible.” If not, he said, “a protest against Europe will develop in Italy, including against Germany, which is seen as the ringleader of EU intolerance, and against the European Central Bank.”<sup>27</sup>

## **China and the Middle East are Particularly Vulnerable**

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In a disorderly collapse, a key question is how the rest of the world will cope with a global depression. Earlier, I argued that Europe was not destined for a return to the 1930s because it enjoys a more robust geopolitical condition. But what is true of Western Europe is not necessarily true of the rest of the world. Just as economic growth can generate political liberalization and reform, so too can an economic downturn put pressure on governments. Those countries which are most vulnerable are those with the greatest economic problems and poor geopolitical conditions—either because their regimes are fragile or because the neighborhood is particularly dangerous.

Therefore, there should be little surprise that 2011 saw the fall of regimes in the Middle East and North Africa, where governments were generally perceived as illegitimate and poor providers of public goods such as economic opportunities and basic services. Indeed, King Abdullah of Jordan made this point explicitly, arguing that the Arab Spring started because of “economic difficulties . . . not because of politics.”<sup>28</sup> A new global depression would bring punishing global

pressures to bear on new and weak governments in the Middle East and North Africa. At a minimum, populism and revolutionary movements would flourish. Some political systems would collapse as people look for alternatives. Governments with resource wealth would be better placed than those without, but they would still suffer as the price of raw materials falls in line with global demand. Political instability inside Middle Eastern countries is likely to bring with it great geopolitical risks. The rise of revolutionary, nationalist, ideological, and revisionist parties is likely to seriously impair regional cooperation, especially with Israel.

China is also highly vulnerable to a global depression induced by the disorderly collapse of the Euro. The Chinese Communist Party has long been assumed to be reliant upon high annual rates of growth. Those would likely evaporate in a global depression as the assumption that legitimacy is a derivative

**The geopolitical climate in Asia is not nearly as benign as in Europe.**

of growth is put to the test. Unlike Western European governments, social unrest in China could lead to demands for a change of political systems or it might lead to the use of militant nationalism as a legitimizing and mobilizing force, with all that might mean for regional instability. Moreover, the geopolitical climate in Asia is not nearly as benign as in Europe. Rising nationalisms would be set against a backdrop of profound uncertainty about the future, territorial

disputes both in land and at sea, unresolved historical grievances, and security competition that is already robust. A more assertive and nationalistic China would reverberate throughout the region, heightening anxiety and sparking counter-reactions.

In the more benign scenario of bare survival, it is possible to imagine that the rest of the world would remain relatively insulated from the worst effects of the European recession, as long as it did not significantly drag down global growth rates. Given the deep economic interdependence across the Atlantic, the U.S. recovery would remain tepid and constrained by Europe's troubles, but the emerging economies—led by China—might continue to grow and reduce the gap with the West. If global growth is relatively unscathed, emerging powers could benefit from Europe's troubles and might be able to insist on a greater say in the governance of global issues, including by increasing their representation in international financial institutions. In this way, the benign scenario might involve an extension of current trends. While the difference between the probability of the two scenarios is relatively small, the effects of the worse of the two are exponentially greater on Asia.

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## The Western Order Would Be Badly Damaged

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Western Europe has been an integral part of the U.S.-led international order since its foundation in the years after World War II. NATO's greatest role was undoubtedly in waging a successful cold war against the Soviet Union while consolidating democracy in Western Europe, but it continues to play a central part in international politics. In recent years, NATO has spearheaded interventions in the Balkans, Afghanistan, and North Africa. Politically and diplomatically, Europe and the United States form a powerful constituency for openness, democracy, and human rights on the world stage, even if they occasionally disagree about how to pursue these goals.

If Europe fails, the transatlantic pillar of the international order would begin to crumble. In the relatively benign scenario of bare survival, Europe would turn inward as it became preoccupied politically, economically, and diplomatically with tackling its own existential crisis. Under such conditions, it is hard to see how Europeans would be willing to play a truly global role in world affairs. Even if they did, military budgets would continue to drop under the constraints of austerity, and the capabilities gap with the United States would widen. Europe's soft power, which optimists have long pointed to as the European Union's real contribution to world politics, would be decimated as European-style integration became a warning to be avoided, not a model to be emulated.

If failure takes the form of a disorderly collapse, the outcome would be immeasurably worse. As Europe reels from the shock of historic proportions, the United States would have to cope with a rapidly worsening geopolitical climate, particularly in the Middle East, North Africa, and China, but also in a number of fragile states around the world. The demand for international leadership and crisis management would skyrocket at precisely the time when a pillar of the West is in a state of collapse. The United States would be compelled to go it alone while Americans would undoubtedly be angered and frustrated at what they would accurately perceive as a European crisis that could have been avoided had better decisions been taken earlier on.

Taking a step back from the fate of the Western alliance, Europe's failure, in either scenario, would be bad news for multilateralism. At the outset, the financial crisis seemed to be a boon for global governance. The crisis demonstrated the need for reform of the global economy, the involvement of emerging powers, and the absolute necessity of international cooperation and coordination. Even better, a ready-made solution was available in the form of the G-20, which enjoyed initial success and appeared to usher in a new era for international financial institutions. Three years later, however, the G-20 has failed to make its presence felt on the Eurocrisis; although the United States and the emerging powers largely agree, they have been unable to convince Germany



to change course. Meanwhile, the major powers in the west have become sharply divided on fundamental questions, including the relative merits of austerity versus stimulus, as well as the nature and scope of financial markets reform. No leader has been able to articulate a future for the global economy and free markets that truly resonates. Few have even tried.

No one is running for the exits. It is clear that economic isolationism and unilateralism will not work. But, it is also apparent that institutions are changing for the worse. Large countries are much more assertive within institutions. They actively undermine constraints upon their freedom of action and clash directly with other states with different interests. If there are asymmetries of power, the larger state will not hesitate to use whatever leverage it has to compel the smaller state to acquiesce to its wishes, as has been the case in Europe.

### The Type of Failure Matters

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## Failure in Europe would shake the world.

Failure in Europe would shake the world. Whether the reverberations are modest or seismic would depend on whether the failure is within existing structures or shatters them beyond repair. The former scenario would ensure Europe becomes less relevant, a coarsening of politics inside the continent, less effective governance over global issues, and the continued relative rise of the rest.

This would be contrary to the interests of the United States and the European Union, but it pales in comparison to the effects of a disorderly collapse which could include a global depression, an end to institutionalized cooperation in Europe, rising populism, potential crises inside China and Middle Eastern countries, and the end of the transatlantic alliance. Although the gap between these two scenarios is great, the difference in the probability of each may be quite small, resting on key political decisions and the impact of various shocks.

Knowledge of the differences between the two types of failures will shape EU politics in alarming ways. If a comprehensive solution to the crisis appears out of reach, for political or other reasons, attention will shift to managing the type of failure that will occur. The countries most affected by the Eurocrisis at present, particularly on the periphery, will become more risk acceptant since they are already paying a high price, and more willing to countenance a breakup of the Euro. If disorderly breakup runs a 75 percent risk of chaos, they will take a chance on the one in four outcome. Maybe the shock will be manageable. Maybe devaluation will offer a path toward growth. However, the rest of the world, including the Euro core countries, will remain highly risk averse. Much as



they may empathize with the periphery's plight, they would prefer the costs and risks to be contained.

In such a scenario, we can expect regular stand offs between the periphery and the rest of the world as the leaders of the former threaten to take down the whole system unless their demands are accommodated. Fiscal transfers will become a ransom the core pays to the periphery. The core will see this as a strategy of blackmail; the periphery will see it as reparations for bearing the bulk of the burden. Regardless of its title, this approach will be attractive to citizens on the periphery battered by economic headwinds and frustrated at perceived German intransigence. What the core's response to this will be is unclear. One can expect numerous standoffs and games of brinkmanship with much scope for miscalculation and disaster. Failure promises to be a very bumpy ride. No-one should be under any illusion about the dangers it will pose to Europe and the rest of the world. Taking this into account should justify unusual levels of political risk taking and extraordinary steps in search for a solution, however difficult and unlikely that may appear.

## Notes

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