The strategic consequences of the Euro crisis

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The malaise afflicting Europe's single currency is damaging the EU's global standing and its ability to act, writes **Charles Grant**. And it's a crisis that will be with us for years to come
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The euro crisis will be with us for many years. The underlying causes, such as southern Europe's lack of competitiveness, cannot be remedied overnight; Greece, Italy, Portugal and Spain face years of low growth, severe curbs on public spending and perhaps social unrest. Many people on other continents now wonder whether the euro is forever, and they also think the EU's hesitant and discordant response to the Greek debt crisis raises questions about the quality of Europe's leadership.

The euro's malaise is damaging not only the EU's global standing, but also its ability to act effectively, in at least four ways.

First, the arguments over how and when to bail out Greece and other countries that may need help have worsened an already fraught relationship between France and Germany. There have been differences of personality and of economic philosophy, with France's impulsive President Nicolas Sarkozy and Germany's dour Chancellor Angela Merkel seeming to wind each other up. At times Herman Van Rompuy, the European Council president, has had to beg them to talk to each other.

The Germans have pushed for stricter rules on budget deficits, with severe penalties for countries that borrow too much. They have even talked about a new treaty that would allow for miscreants to be expelled from the eurozone. But the French have emphasised the need for governments to discuss each other's policies and performance as well as imbalances within the eurozone. The French government opposes a new EU treaty, and Paris and Berlin have also clashed on whether to involve the IMF, on whether the European Central Bank (ECB) should buy governments' bonds and on whether the key forum for economic governance should be the euro group or the wider EU.

It is true that at each stage of the crisis France and Germany have in the end found a compromise – which they have then obliged the other member states to swallow. But the coolness between Merkel and Sarkozy matters. The EU can achieve very little – including in foreign policy – without France and Germany working together effectively.

Second, the Greek crisis has highlighted

Germany's growing isolation within the EU. Ever since reunification, Germany has gradually been asserting its interests more forcefully, in the way that Britain and France always do. In an enlarged EU of 27 members, Germany's leaders no longer assume that what is good for Germany is good for the EU, and vice versa. On issues like energy and Russia they have sometimes opposed a common EU position on the grounds that Germany's own interests could be harmed.

This year, many member states – and the European Commission too – have criticised Germany for not doing more to stimulate demand in the eurozone, and thus help the southern Europeans to grow at a time when they are slashing public spending. German politicians respond that higher domestic consumption would do little to help southern Europe, and that public opinion in Germany constrains them from aiding profligates. Many Germans feel they are being asked to become less competitive. They are not entirely on their own in these arguments; the Dutch, Finns and Austrians all support the German emphasis on budgetary discipline. But a lot of Germans, hurt by criticism that they regard as unfair, are keen not to subordinate their interests to those of 'Europe'. Never before in the history of the EU has Germany been so disconnected from most of its partners.

Third, the euro crisis has weakened the Brussels Commission, whose power – relative to EU member governments – has been in slow decline for about 20 years. When the financial crisis struck in 2008, it was the larger member states that led the EU's response, partially sidelining the Commission. And though the Commission helped to design the €500bn package agreed in May of this year, the EU governments will control the largest pot of money, the European Financial Stability Facility. The IMF and the ECB will play a role in setting the conditions that apply to those borrowing from the facility.

In Paris and even more in Berlin there is growing contempt for the Commission. They accuse it both of interfering in too many areas and of failing to lead during the crisis. The Commission responds that its job of policing competition policy inevitably upsets the big members, and that the national capitals often do their best to prevent Brussels from taking the lead. The Commission's job is to promote the wider European interest, so the weaker it becomes, the greater the danger of governments pursuing their particular interests, to the cost of the EU.

Fourth, the euro crisis is making the EU introspective. For the past ten years the emphasis on treaty change has forced European leaders to spend too much time and energy on institutions and procedures. Many had hoped that with the Lisbon treaty out of the way, the EU would at last focus fully on big global challenges like Russia, China, energy and climate. But the EU's hesitant and muddled response to the Greek debt crisis has set off a game of mutual blame. Europe may have to endure several years of emergency summits and bail-outs, sowing discord and undermining trust between the member states.

None of this means the euro or the EU will fall to pieces. For all their imperfections, Merkel and Sarkozy are the best leaders Europe has got and they will find ways of working together. Germany will in the end do what is necessary to keep the euro stable, and EU governments will grudgingly accept that they need the Commission. Crises on other continents will also force EU leaders to raise their eyes to the wider world.

Nevertheless the EU's uncertain handling of the euro crisis has greatly tarnished its soft power. Key people in Washington, Moscow, Beijing and New Delhi have become even more dismissive of the EU than they already were. So what can the EU do to limit the damage and revive its global reputation? To begin with, the Union needs to fix its economy. For decades Europe has grown more slowly than other continents. The remedies required are well-known – they were set out in the Lisbon Agenda that was agreed in 2000 and have now been repeated in the Commission's recent EU 2020 programme. But too few governments have embraced structural reform. The southern Europeans have a particularly poor record, which accounts for some of their present travails. But constraining public spending is not enough; many EU states also need to liberalise their labour markets, reform universities and schools, remove red tape, modernise pensions systems and create the conditions which encourage entrepreneurialism and innovation. This summer, the Greek and Spanish governments have appeared – belatedly – to be taking some of the right steps.

The EU's governments need to agree on major reforms to eurozone governance. The broad lines are fairly clear – stricter budgetary discipline, more mutual surveillance of economic policies, and a mechanism for dealing with governments that need to restructure debt (as Greece will probably have to do). Such changes do not require a new EU treaty, which in any case most EU governments oppose. Some eurozone banks will probably need to be recapitalised.

Germany needs to accept that eurozone governments will have to discuss imbalances in the euro area; but Germany's partners should relent in their urging of Germany to reflate, which might be counter-productive. Rather, they should ask Germany to embrace structural economic reforms that would in the long run lead to a more balanced economy. Many German economists know that the country needs to shift away from dependence on exports towards higher levels of domestic consumption. Longer shopping hours, labour market reforms that encouraged employers to take on staff (and thus raised the cost of labour) and better childcare so that more women worked would all boost spending.

The EU's 'big three' countries also need to work together in ways that convince the rest of the world that Europe has serious leaders who will do what it takes to stabilise the eurozone. Although the Britain is outside the euro, what Britain says and does plays an important role in shaping global perceptions of the EU. Prime Minister David Cameron has made a good start by adopting a constructive attitude to the EU. He has made it clear that he understands it is in the British national interest for the eurozone to overcome its difficulties.

Germany's leaders need to do much more to educate people on the benefits of the euro. The business and political elites know that the eurozone provides German exporters with a large market of rather uncompetitive countries that buy their goods. Yet many Germans believe the euro is a burden. Merkel must explain that Germany is paying into the bail-out funds not for idealism or altruism but out of self-interest.

France and Germany need to avoid public squabbles and revive their close alliance, so Merkel and Sarkozy must learn to tolerate each other's foibles. France will have to accept more binding rules and budgetary discipline than it would wish, while Germany will have to tolerate group discussions of its economic policy. Germany will also have to accept that if Northern Europeans cannot provide the demand that helps to pull the southern states out of a vicious circle of slow growth and public spending cuts, they will have to cough up for the transfer payments required to hold the eurozone together.

In Brussels, much energy has gone into building the new External Action Service, in the hope that it will foster a more coherent EU foreign policy. Let us hope that it does. But what would really improve the EU's global standing would be strong economic growth, a convincing set of rules for the eurozone and the perception that Europe has tough and far-sighted leaders.