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# Europe Reborn

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## How to Save the European Union From Irrelevance

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*Matthias Matthijs and R. Daniel Kelemen*

**I**n 1982, *The Economist* marked the 25th anniversary of the European Economic Community, the precursor to the European Union, by featuring a tombstone dedicated to the organization on its cover. “Born March 25, 1957. Moribund March 25, 1982,” it read. Then came an epitaph courtesy of the ancient Roman historian Tacitus: *Capax imperii nisi imperasset*, “It seemed capable of being a power, until it tried to be one.” Inside, the magazine pilloried the community for its institutional weakness, bemoaned its citizens’ growing disenchantment with European integration, and warned of a possible British exit.

Yet those dark hours marked the dawn of the European project, not its dusk. Just three years later, Jacques Delors, the former French finance minister, became the European Commission’s eighth president and immediately injected a dose of vitality into the sluggish organization. His campaign to create a single market in Europe—an initiative that enjoyed enthusiastic support from British Prime Minister Margaret Thatcher—paved the way for the 1992 Maastricht Treaty, which established the EU. During Delors’ decadelong tenure, the union strengthened its institutions, extended its authority into new policy areas, and welcomed five new member states. In the early 1990s, opinion polls found that 70 percent of Europe’s citizens favored EU membership and less than ten percent opposed it. Within a decade, European integration had risen from the grave; the EU had proved itself to be far more resilient than even many of its supporters had expected it to be.

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This is a curious bit of history to recall today, as critics ring the EU's death knell once again. They point to a familiar list of omens—institutional impotence, voters' disillusionment with Brussels, and the threat of losing the United Kingdom—to suggest that the organization may soon unravel. Doomsayers can be found across Europe's political spectrum. They include Euroskeptics on the far right, such as the leader of France's National Front party, Marine Le Pen, who declared in October 2013 that the EU would "collapse as the Soviet Union collapsed." They also include Europhiles on the political left, such as Joschka Fischer, Germany's former foreign minister and longtime Green Party leader, who recently warned that the EU was in danger of implosion.

This time around, the EU indeed has serious reasons for concern. Public trust in EU institutions has hit all-time lows, and Euroskeptical parties made record gains in elections for the European Parliament in May 2014. And the EU's economic challenges today far exceed those of 30 years ago. Although the continent appears to have weathered the worst of the eurozone crisis, which roiled Europe between 2009 and 2012, Europe's economy remains in dire straits. Some feeble signs of recovery aside, the EU continues to teeter on the brink of deflation and risks falling into a triple-dip recession, as growth languishes and unemployment levels hover near record highs in southern Europe. Many citizens, especially the young, no longer associate the EU with greater freedom and opportunity; instead, they blame it for financial pain, prolonged joblessness, and a lack of democratic choice. Compounding the problem, the EU has appeared weak in the face of Russia's aggression on its doorstep and Hungary's slide toward autocracy within its own borders.

Reversing the EU's flagging fortunes will not be easy, but the relentless focus on its problems has obscured another reality. A convergence of factors—including capable new leaders, the gradual emergence of a new economic policy consensus, and, paradoxically, the mounting threats to the EU's territorial integrity from outside and within—offers Europe a window of opportunity in which to revive the union, recast its policies, and win back public support. To pull off such a turnaround, the EU will first have to get its economic house in order, refocus on growth, and fix the governance institutions that stand behind its common currency. European leaders must also adopt a more resolute and unified stance on security in order to strengthen the EU's geopolitical role in its neighborhood. Moreover, the EU must reclaim its credibility as a bastion of economic and political freedom,

defending not only the integrity of the euro system but also the shared democratic values that bind together its member states. All of those steps are possible, however, and if they are taken, the union's future will be much brighter than critics expect.

The stakes could not be higher. A failure to act decisively would lead to further stagnation and, ultimately, irrelevance. But taking resolute steps could poise Europe for another rebirth.

### **IN GOOD HANDS**

A number of recent developments have converged to create a rare political opening for the EU. First, the organization's new crop of leaders promises to be the strongest to head the organization since the Delors era. Foremost among them is Jean-Claude Juncker, the European Commission's new president. The cognac-sipping Luxembourgish has faced criticism for belonging to the EU's old guard and therefore being an unlikely candidate to rejuvenate Europe. But Juncker can turn this weakness into his main strength. His vast institutional knowledge—he might have sat through more European Council meetings than anyone alive—makes him far better prepared than his predecessor, José Manuel Barroso, was to help Europe's decision-makers break through logjams and seal deals.

Juncker also enjoys the respect and backing of most heads of European government, having helped them navigate past economic crises as the former chair of the Eurogroup, a council of the eurozone's finance ministers. And thanks to a change in the process through which the president of the commission is elected, Juncker also has an explicit mandate from the European Parliament. Prior presidents were appointed directly by the European Council, before the parliament endorsed them. But in 2014, the parliament managed to link the president's selection directly to the outcome of the parliamentary elections: the body's party groups nominated candidates who then campaigned for the post. When the center-right European People's Party, which nominated Juncker, emerged victorious in the May 2014 elections, the parliament pressed national governments to select him. Juncker thus became the first commission president to have been elected, albeit still indirectly, by EU citizens—a position that equips him with greater authority to shape EU policy than his predecessors had.

Moreover, Juncker embodies the sensible centrist coalition that has powered every previous successful grand bargain over European



*Curtain call: hanging the EU flag in Barcelona, May 2008*

integration. Indeed, he is probably “the most socialist Christian Democrat there is,” in the words of Daniel Cohn-Bendit, a left-wing German member of the European Parliament. And in performing his job, he will be backed by an impressive new team of European commissioners (who together make up the EU’s executive arm and manage its policy portfolios). This set of incoming commissioners includes more heavyweight political players than any preceding group: nine former prime ministers or former deputy prime ministers and 19 former cabinet ministers.

Meanwhile, the European Council will be headed by former Polish Prime Minister Donald Tusk, a far stronger leader than his predecessor, the inconspicuous Herman Van Rompuy of Belgium (who was nicknamed the “gray mouse” of European politics for his unassuming leadership style). Tusk is one of the few EU leaders who won reelection after the global financial crisis. Following his victory, he went on to shepherd Poland through three additional years of steady economic growth, even as most of Europe faltered. And his strong working relationship with Chancellor Angela Merkel of Germany has invited hope that the duo, dubbed “Tuskel,” will prove more effective at holding Europe together than was the odd couple known as “Merkozy”—Merkel and former French President Nicolas Sarkozy, whose often crackling partnership defined the EU’s hesitant early response to the euro crisis.

These new leaders are taking charge at a time when a new economic consensus has finally begun to take shape. Fearing deflation and yet another recession, European policymakers have become wary of the EU's narrow focus on austerity. Supporters of austerity, led by Merkel, champion budget discipline as the only way to restore European financial stability, but the policy has also produced adverse side effects, including persistently high unemployment and dangerously low levels of inflation. Many European leaders have grown increasingly desperate to stimulate economic growth. The most visible proponent of this emerging consensus is the president of the European Central Bank, Mario Draghi, who last August told a group of the world's central bankers that European governments should work in concert with the bank to encourage lagging consumption and investment—a vision, dubbed “Draghinomics” by some, that has been steadily gaining supporters.

### **CIRCLING THE WAGONS**

External and internal threats to European unity have also yielded a renewed sense of solidarity. Nothing focuses the European mind quite like the sight of Russian tanks rolling westward. In the two decades preceding the Ukraine crisis, EU countries repeatedly promised to integrate their security and defense policies but failed to deliver. Yet unions of states tend to pull together when their members confront a common external threat. Ironically, Russian President Vladimir Putin just might be the leader who will finally succeed in pushing Europe to cooperate on defense after all others failed.

Indeed, a resurgent Russia on Europe's doorstep has finally spurred the EU to action. Although member states had initially been split in their reactions to the Russian annexation of Crimea in March 2014, Moscow's continued intervention in eastern Ukraine and the downing of Malaysia Airlines Flight 17 over Ukraine in July (almost certainly by Russian-backed separatists) have brought about a much-needed display of unity. The EU has since responded by imposing retaliatory sanctions on Russia and renewing its efforts to cut its reliance on Russian energy.

In another encouraging sign, this closing of the ranks enjoys wholehearted U.S. support—a marked change from 12 years ago. Back then, during the transatlantic rift over the Iraq war, Washington's policy reinforced the division between old and new Europe. The new U.S. approach to European security, however, rests on two watchwords: pooling resources and sharing the burden.



Just as Russian saber rattling has forced EU countries to draw closer, so, too, could the threat of a British exit ultimately strengthen the union. An attempt by the United Kingdom to leave the EU would almost certainly spark a more pointed continent-wide conversation about the benefits of European integration.

British Prime Minister David Cameron has promised to hold an “in or out” referendum on the country’s EU membership by the middle of 2017 if his Conservative Party wins this year’s elections. But even if a referendum does take place, an “out” vote appears unlikely—in large part because Cameron himself would work to avoid it. An exit not only would damage the British economy but also could trigger a renewed push for independence by Scotland, which remains more pro-EU than the rest of the United Kingdom. His bluster aside,

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*Many Europeans no longer associate the EU with freedom and opportunity; instead, they blame it for financial pain.*

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Cameron dreads this outcome. He would far prefer a different scenario: lobbying the EU for greater concessions before personally campaigning for an “in” vote. For their part, Juncker, Merkel, and Tusk have all emphasized their willingness to work with the United Kingdom to address its concerns, short of limiting the EU’s free movement of workers. In fact, during his presidential campaign last spring, Juncker promised to work out a “fair deal” with London.

If Cameron can win adequate concessions for the United Kingdom, then a British referendum could actually end up strengthening the union. The run-up to the vote would likely include a spirited campaign in favor of the “in” option, during which Cameron would extol the benefits of EU membership and other major European leaders would implore the British people to remain in the European family. A display of solidarity of this kind would represent a welcome change from the routine hurling of blame at Brussels by European leaders looking to deflect attention from their own policy shortfalls. It would also remind Europe’s citizens of the benefits the union affords them. An “in” vote by the United Kingdom would put the issue to rest for at least a generation, bolster public support for the EU across the continent, and give EU policymakers the boost necessary to undertake critical reforms.

## GROWING PAINS

To seize the opening before them and reboot the European project, EU leaders must pursue a new agenda. Taking bold, decisive action on a number of fronts would revive the European economy, win back disenfranchised voters, and reestablish the union's authority on the world stage.

First, European policymakers must shift their economic focus from austerity and fiscal rules to investment and growth. For too many years, EU economic policy has been dictated by German fiscal conservatives, imposing unsustainable demands on member states on the eurozone's periphery, such as Greece and Portugal. The emphasis on austerity might have been politically necessary when the euro crisis began, providing a dose of pain to discourage governments from expecting future EU bailouts. But this policy has also stunted growth, encouraged deflation, and fed resentment across the continent. The time has come for European leaders to halt their single-minded and self-destructive pursuit of budget tightening.

New economic evidence shows unambiguously that too much austerity can deepen economic downturns; fiscal stimulus, by contrast, can produce a far greater boost to growth when implemented during severe recessions. Even the International Monetary Fund, generally a proponent of reining in government spending, criticized the EU's pursuit of austerity as too dogmatic in its 2012 *World Economic Outlook*. It also warned, in a 2013 analysis, that excessively low inflation was aggravating income inequality in the eurozone by deepening unemployment and stressing the poor. German resistance has so far prevented a loosening of the rules, but Germany looks increasingly isolated in its rigid stance. It appears likely that looming deflation and flagging growth could strengthen Germany's support for broader investment initiatives—and even make the country more willing to tolerate slight reinterpretations of fiscal rules.

To roll back austerity, EU leaders could borrow a page from Japanese Prime Minister Shinzo Abe's "three arrows" playbook and combine two short-term fixes—monetary expansion and fiscal stimulus—with longer-term structural reforms. On the monetary front, Draghi has already fired the first arrow, pledging in 2012 that the European Central Bank would do "whatever it takes" to save the euro. This past October, the bank began a round of private-sector quantitative easing, purchasing bank assets to inject cash into the economy. In this round, the bank committed itself to buying one

trillion euros in covered bonds (low-risk debt securities issued by banks) and asset-backed securities (bundles of loans that banks package and resell) in order to clean up the balance sheets of euro-zone banks and spur private lending to businesses.

These initial measures disappointed some investors, who feared that there were simply not enough such assets in the EU market and had hoped that the European Central Bank would commit to buying sovereign bonds—a more radical option that remains on the table. But the purchases have demonstrated that the bank stands ready to take decisive measures to stimulate the European economy.

Quantitative easing alone is not enough to rekindle growth, however. This policy must work in concert with the second arrow: fiscal measures that would directly stimulate lagging demand. The European Commission looks set to do its part. A new 300 billion euro investment fund proposed by Juncker would raise aggregate demand by channeling money into infrastructure projects and add firepower to the European Investment Bank. But policymakers must take more steps at the national level, where the real budgetary resources lie. Europe's stronger northern economies should stimulate demand through fiscal measures. Germany, in particular, should allow its wages at home to rise faster than in the rest of Europe in order to boost German citizens' purchasing power.

Finally, EU governments need to make more headway on the third arrow by liberalizing their labor and services markets. These measures would make it easier to hire and fire people and allow for more competition. Policy shifts of this kind would cause inevitable pain to vested interests and previously sheltered sectors, which explains why they have been so hard to implement. Tough reforms, however, would be easier to push through in the climate of growth that fiscal stimulus could help generate.

## **SHORING UP THE EURO**

EU leaders must also restore confidence in the euro and the EU's monetary union. Perhaps miraculously, despite its travails, the single currency remains popular with European voters. Over two-thirds of the eurozone population supports the euro today—the same percentage as before the crisis. European leaders should demonstrate that they, too, continue to stand behind the euro and will ensure its stability in the future.



From its inception, Europe's economic and monetary union was incomplete in crucial respects. The introduction of the euro centralized monetary policy but left fiscal policy largely in the hands of national governments. This dichotomy has made it difficult to adjust to economic shocks that affect member states differently. Moreover, although the single market allowed banks to offer financial services across borders, the responsibility for regulating these banks fell to individual governments. The dangers inherent in that structure became apparent as the eurozone crisis unfolded and cascading banking crises threatened the solvency of member states that lacked adequate rescue mechanisms. To paraphrase Mervyn King, former governor of the Bank of England, EU banks were European in life but national in death.

EU leaders reacted with a series of reforms that addressed deficiencies in the eurozone's governance and restored some measure of stability. But this work remains incomplete. In particular, the EU's banking union—encompassing a set of rules and institutions that would supervise and regulate eurozone banks—remains half-baked and inherently vulnerable to future shocks. The EU should now bring this project to completion.

As part of the effort, the EU should consider introducing common deposit insurance and accelerating the establishment of an emergency credit line for failing banks. These measures would help transform the public image of the EU from an enforcer of austerity to a protector of wealth. Depositors visiting eurozone banks, for example, should see clear placards (similar to the ubiquitous Federal Deposit Insurance Corporation stickers displayed at U.S. banks) assuring them that the EU guarantees their savings.

The EU has taken major steps toward the banking union over the past three years: it has empowered the European Central Bank to regulate Europe's largest banks and set up the Single Resolution Mechanism, a central authority for handling bank failures. So far, however, it has not put in place a centralized system of deposit insurance. Moreover, the Single Resolution Mechanism remains incomplete, and its policies remain far too convoluted to effectively deal with large bank failures. Germany has led the opposition to these measures, fearing that German savers might eventually be forced to bail out depositors in Italy, Spain, and elsewhere. Defenders of the eurozone should counter this narrative by stressing that a stable currency

union—which Germany favors—will eventually require a banking union with common deposit insurance and a common fiscal backstop.

Finally, in the longer term, the EU should consider issuing limited amounts of eurobonds, a common instrument that would pull together the debts of the countries using the euro. Merkel and German Finance Minister Wolfgang Schäuble have consistently opposed such a move, out of fear of building what they call a “debt union.” Admittedly, even a well-designed and limited eurobond scheme would create some moral hazard. But advocates of this strategy must stress its many potential benefits. Eurobonds would ensure financial-market stability, enhance the euro’s standing as a global reserve currency, increase the liquidity of the European bond market, and provide the eurozone with the common safe asset it so desperately needs in times of crisis. These assured benefits far outweigh the potential costs.

### **A BASTION OF VALUES**

Even as European countries deepen their economic integration, they must remember that European values are just as important to defend as financial stability. Russia’s aggression in Ukraine has provided a dramatic reminder of the security risks European countries face—and of the EU’s persistent failure to craft unified foreign and security policies. This shortfall is not for lack of public support. According to Eurobarometer surveys (regular polls conducted by the European Commission), despite the growing disillusionment with the EU, more than 70 percent of Europeans—including majorities in every member state—want the union to develop a common security and defense policy. Yet national governments have thus far ignored their publics’ wishes and remained loyal to their countries’ powerful national defense industries.

Ironically, the United Kingdom’s quest to renegotiate the terms of its EU membership might offer a rare opportunity to break the impasse. As European leaders try to accommodate the United Kingdom’s demands for reform in other areas, they should encourage the country to take on a stronger leadership role on foreign and security matters. As a start, the United Kingdom could lead efforts to press other member states to live up to their previous commitments to pool defense resources and share military capabilities. Although the notion that the United Kingdom would approve a truly common European defense policy may seem far-fetched today, it is not an impossible proposition. As its own military budget shrinks and its risk of becoming a second-rank military

power grows, the United Kingdom could be tempted by the allure of saving costs while enhancing its prestige to assume greater leadership.

More fundamentally, there can be no credible European security and defense policy without the United Kingdom, the country that remains Europe's strongest military power (rivaled only by France). Inviting London to take on more responsibilities in this area would go some way toward offsetting its lesser involvement in other fields of European integration and its absence from the monetary union.

The EU's collective security would benefit from greater cooperation in other fields as well. Energy policy is a case in point. A sure way to counter Russia's stranglehold on European energy supplies is to establish a true European energy union—a path that Tusk advocated last spring. If created, this institution would jointly negotiate gas contracts on behalf of all EU member states and coordinate their responses should Russia interrupt its deliveries. An energy union would also help augment infrastructure needed to import liquefied natural gas from other suppliers, including the United States. Even though progress in this arena has been slow—due to conflicts of interest and disagreements among countries on burden sharing—the threat to energy supplies posed by Putin's increased aggression may convince Europe to unite.

Internal threats to the EU's integrity might prove even more dangerous than external ones, and the EU must act decisively to defend democracy and the rule of law inside its borders. A number of EU member states have experienced democratic backsliding in recent years. Hungary, above all, represents a critical test of the EU's resolve. Since sweeping to power in 2010, Viktor Orban, Hungary's prime minister, has eliminated democratic checks and balances, undermined judicial independence, hobbled independent media, installed loyalists in nearly all key government positions, and rigged election laws to favor his own party. In July, Orban publicly declared his intention to abandon liberal democracy in favor of building an "illiberal state," citing China, Russia, Singapore, and Turkey as role models. Despite these developments, however, Hungary has remained an EU member state in good standing. The EU's tentative response—issuing critical reports and bringing legal actions before European courts—has failed to deter Orban and has raised profound doubts about the union's political will to defend the very values it claims to represent.

The EU must take a much tougher line with the Orban regime. The European Commission should launch the so-called Article 7 procedure, which would allow the European Council to suspend Hungary's voting

rights owing to serious and persistent breaches of the EU's fundamental values. And more important, EU leaders need to denounce Orban's actions. For far too long, leaders of the European People's Party faction in the European Parliament, a group that counts Orban's own political party as a member, have shielded Orban's government from criticism in the interest of partisan loyalty. These leaders—who include Juncker, Merkel, and Tusk—must now declare that Orban's tactics betray the principles for which they and the rest of Europe stand.

To date, Orban has often succeeded in turning EU criticism to his advantage with populist rhetoric that accuses Brussels of meddling in Hungary's internal affairs. But if center-right leaders from across Europe—members of Orban's own political family—join EU officials in denouncing his actions, Orban will not be able to continue to spin this tale.

The EU presents itself as a union of democratic values and has exerted a magnetic pull on neighboring countries undergoing democratic transitions. The recent pro-democracy protests in Ukraine, which toppled the corrupt Yanukovich government in February 2014, were a reminder that those struggling for democracy view the EU as a bastion of freedom. But if the EU allows even one member state to slide into autocracy, it will irreversibly diminish the meaning of EU membership.

## **EURO-MOJO**

Skeptics have been planning the EU's funeral for decades, but time and again, the union has refused to die. During the EU's latest and most profound crisis, national governments once more chose to reaffirm and deepen their commitments. This rapid growth of EU power, however, has given rise to a number of misguided and counterproductive policies that have undercut public support and left the EU in a deep malaise. European citizens today largely ignore the EU's many achievements or take them for granted, instead equating the organization with economic pain and feckless leadership. The union endures, but it has lost its mojo.

The EU has worn out its default strategy of muddling through crises. Lurching from one calamity to the next has damaged the credibility of Brussels and national governments alike. It is time for a bold and far-reaching agenda. To see a Europe truly reborn and fit for the twenty-first century, EU leaders must reassert with confidence—on the economy, on security, and on democracy—that Europe is stronger when it stands united. 🌐