

FAREED ZAKARIA: IRAN AND THE LIMITS OF AMERICAN POWER

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## IN DEFENSE OF EUROPE

BY ANDREW MORAVCSIK



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POLITICS

# IN DEFENSE





# OF EUROPE

GREEK PROTS  
INSPIRE THE  
FORECASTS OF  
EUROPE'S FALL.

NOW MORE THAN EVER,  
IT'S NOT SMART TO BET  
ON THE EU'S DEMISE.

BY ANDREW MORAVCSIK

IN ANCIENT GREECE, CASSANDRA warned of the fall of Troy, and no one listened. Today, after the Greek financial crisis, Cassandras are everywhere, predicting the collapse of the euro, if not the European Union itself. Everyone is listening.

Yet extreme pessimism is premature. History teaches us that it is too soon to count Europe out. Headline-chasing observers have often predicted the Union's imminent demise. They have generally been proved wrong. In the 1960s, when France's President Charles de Gaulle vetoed British entry and withdrew from the Common Market, bringing European decision making to a halt for six months, some believed the experiment was finished. In the early 1980s, journalists used the phrases "Euro-sclerosis" and "Euro-pessimism" to describe the mood in Brussels. A few years later, Europe launched the single-market program. Economists uniformly rejected the euro as unworkable. Now it is reality. Just five years ago, in the wake of referendum defeats in France, the Netherlands, and Ireland, the European Constitution seemed moribund. Now it is law.

European countries consistently find common solutions not because they are sentimental believers in the European ideal but because they inhabit the world's most economically interdependent continent. They have no choice but to cooperate. Witness the result of the May currency crisis: a stronger Europe but without the extreme centralized federalism some advocate. On May 10, Europeans bailed out Greece, authorized

IN ATHENS,  
PROTEST  
AGAINST  
CUTBACKS.





a €750 billion war chest to protect currencies, and authorized the European Central Bank to intervene to buy up sovereign debt.

Euro-zone leaders Germany and France did not agree to tie their fates to debtors because they feel great solidarity for Greece—a country whose early retirement ages and dodgy accounting have been pilloried in the German press. Nor were they motivated by enthusiastic belief in the European project: those idealistic days are long gone. Bank bailouts, European or national, are no more popular in Europe than in the U.S. That's why the German government delayed so long before supporting the rescue, as Chancellor Angela Merkel's Christian Democratic party hoped (unsuccessfully) to avoid a thrashing in regional elections.

Nor did France or Germany act in order to prop up the euro, which has lost nearly 20 percent of its value since November. After all, the European currency was trading last week at about 1.25 to the dollar, close to what it was at its inception. A further decline would be good for major exporters like France and Germany. Merkel did not act because President Obama called her—as was conveniently leaked to the German press. Europeans don't risk their currency to do favors for the Americans.

European politicians made, rather, a hard calculation of self-interest: they acted to avoid a disastrous loss of con-

fidence in French and German banks and bonds, which are linked to Greece. French banks hold €58 billion of German debt, and German banks owe €32 billion—far more than Greek banks. (No wonder French President Nicolas Sarkozy led the charge.) Ninety percent of Greek debt is held by foreigners.

Over the weekend preceding the intervention, markets panicked, fearing an imminent Greek default. Interbank and government financing costs rose to unsustainable levels. The contagion began to spread to the other PIIGS countries: Portugal, Ireland, Italy, and Spain. The crisis was, according to one banking insider, “as acute as any seen since the weekend of the failure of Lehman Brothers.” If Greece had gone under, the entire European banking system might have gone with it. Germany and France did not bail out foreigners; they bailed out their own people. Self-interest left them no choice.

What happens now? Commentators persist in viewing the crisis as a black-or-white battle: pessimism or idealism.

Pessimists see a euro-zone breakup as all but inevitable. Divergence—differences in competitiveness, government budgets, labor costs, and demography—must ultimately drive European countries apart. Germans and Greeks, perhaps even Germans and French, in the same monetary union is bad policy because it suppresses growth in less-competitive countries, which can no

longer devalue to boost exports and suppress consumer spending.

In today's volatile markets, pessimists believe, no amount of government intervention will ultimately stop speculators from tearing them apart. It is bound to create resentments within the EU. Pessimists also believe it is better to encourage weak nations like Greece to leave the system—at least temporarily, as Harvard professor Kenneth Rogoff suggests—in order to devalue their currency and reestablish competitiveness.

True, a few countries, perhaps Greece, may ultimately leave the euro zone. But for most, the costs of pulling out of the euro are prohibitively high—enough to dissuade any politician from deliberately risking such a course. Businesses would undergo a wrenching transition, Euro-denominated debt would balloon, costly austerity would still be necessary. The risk of defaults, lawsuits, and disruption of trade and investment would be high—placing the financial system in jeopardy.

Idealists believe the EU's only alternative is centralization, a transfer of control over national budgets and policies to the EU. Former commission president Romano Prodi wants to see European “fiscal federalism.” Strict enforcement by Brussels or Frankfurt is, in this view, the only way to encourage governments to undertake reform. Rules with real teeth are needed to replace the stability pact adopted in 1997, which caps national





deficits at 3 percent. Even France and Germany did not always have to adhere to this pact. Even critics see it this way. Niall Ferguson, no Europhile, recently wrote in these pages: “The real choice is between becoming a fully fledged United States of Europe... and a gimcrack hodgepodge... that will sooner or later fall apart.” Since many of the problems go well beyond budgets, such an authority would have to extend to the details of national taxation, spending, and regulatory policies as well. Such a “United States of Europe” has long been the dream of European federalists.

Some movement in this direction can be discerned. European leaders will meet next month to discuss a new stability pact, with real penalties for noncompliance, proposed by Germany. Yet there are limits to any centralized strategy. Commission President José Manuel Barroso publicly labeled the German proposal “unrealistic.” Brussels has no mandate to dictate national solutions in sensitive areas like pensions, social welfare, and labor flexibility. Such policies succeed only when they reflect carefully crafted deals among parties, unions, and businesses specific to particular countries. Governments jealous of their sovereignty are loath to transfer these policies to technocrats.

Between pessimism and idealism there remains a third, more pragmatic option—one more consistent with the vital national interests of European governments. The

Greek bailout gives Germany, France, and other lender countries the time—perhaps a matter of months or, with luck, a few years—to restructure their banking sectors. Part of the problem is that Germany and France have yet to take the sort of politically controversial action America and Britain have: spending massive sums of taxpayer money to identify and remove “toxic” assets from their bank balance sheets. Now they must do this, in the process inevitably reducing their exposure to Greece and other PIIGS. Meanwhile, the EU needs to develop rules for orderly default, perhaps backed by bridge financing from the EU or a new European Monetary Fund. As a last resort, withdrawal from the euro should be an option.

With the rest of the euro-zone banking sector more safely insulated, Greece and others will be allowed to default, paying back creditors some fraction of the total they owe. Few governments tolerate debt repayments at the level of 7 to 10 percent of GDP for long. This is no catastrophe. “Restructuring” is the polite word for what European countries and American municipalities did in the 1970s, and numerous Latin American and Asian countries did more recently.

The pragmatic solution rests in part on the hope that the recent shock will prod reform in nations like Spain, France, and Belgium—on whose continued participation the euro zone depends. Just as Britain’s brush with the IMF in 1976 helped

trigger reforms in the 1980s and 1990s, we can hope that this will occur elsewhere today. One reason will be that private banks and bond markets will punish governments that fail to reform. Already, the interest rates banks charge Greece have risen from 1 percent above German rates to more than 10 percent. This will give such governments incentive to reform—without direct EU oversight. German Finance Minister Wolfgang Schäuble recently proposed that euro-zone members adopt constitutional provisions limiting budget deficits, as Germany has.

The EU is succeeding because its policies are not based on idealism but on the recognition that a union of diverse nations can find realistic ways to work together. The commitment of Europeans to one another is not unconditional, as federalists believe, but it is stronger than skeptics fear. The European style of muddling through may be unglamorous, but it works. Those who bet against the economic self-interest of European governments are likely to lose.

MORAVCSIK is professor of politics and director of the European Union program at Princeton University. He is author of *Power, Interdependence and Non-State Action in World Politics*.

**NEXT ▶**

**WHY ARIZONA SHOULD OPEN ITS DOORS**

The angry state needs more immigrants, not less.

BY ARIAN CAMPO-FLORES

FROM LEFT: BERASIMOS KOILAKOS—GREECE INVISION-AURORA (2)