

Notes on the future of Europe

After two generations, the process of European integration as we know it seems to have reached its limits. European integration has been a response to the wars that ravaged the continent until 1945 and to the protectionism that wrecked many economies in the inter-war years. Starting with the six-nation coal and steel community in 1952, the institutionalised cooperation between sovereign nation states in Europe has always grown in scope and size, spreading to a rising number of countries and to more and more policy areas. A different pattern is now emerging.

Whether or not the UK votes itself out of the European Union on 23 June, Europe is changing. Ahead lies a more variable geography as groups of countries choose on which matters they want to cooperate more closely and on which issues they don't.

The key question for Europe will be whether the transition can be fairly smooth or will be highly disruptive. Will the continent preserve and build on the huge achievements which European integration has delivered so far or fall back into a fragile state closer to the dark ages of the 1930s with rampant economic and political nationalism and mounting security risks? We take a look at some of these issues.

A Brexit would accelerate the changes and raise the risks that the process could be disruptive and painful. Our base case is that reason will prevail, with Europe by and large preserving its achievements.

The forces of change in Europe

- **Success breeds complacency.** If something works long enough, people take it for granted, tending to neglect the foundations on which their wellbeing rests. They feel bothered by the need to abide by some common rules for a common market and hemmed in rather than liberated by the opportunities which the free movement of labour grants them and their neighbours.
- **More internal diversity, less of a unifying external threat.** Until 1990, the communist threat had served as a constant and potent reminder to western European countries why they needed to work together closely; the fall of communism in 1989 removed this external discipline. Instead, the welcome admission of many post-communist countries into the European Union (EU) from 2004 onwards turned the EU into a much bigger and more diverse club. Very different historical experiences and narratives shape the political discussions in the various member countries.
- **The tide of anger.** On both sides of the Atlantic, voters have been drawn to populists from the ultra-right and ultra-left of the political spectrum. Short on arguments but long on rhetoric and flamboyant hairdos, the populists have skilfully harnessed stratified social media in which mainstream views are often drowned out in favour of circles whose members reinforce each other's prejudices. The tide of anger seems to be a response to rapid structural and technological change, to immigration and other perceived indignities of globalisation and a protest against the pain of fiscal repair after the Great Financial Crisis of 2008/2009.

The rise of populism is similar in the US (Donald Trump) and Europe (Marine Le Pen, Beppe Grillo), we find it inside the Eurozone ("The Finns Party") and outside ("Sweden Democrats"). In Europe, however, the damage that populists could do is greater than in the US. As a club of sovereign nations, the EU is easier to break than a nation state. In the US, a President Donald Trump would still reside in the White House in Washington, DC. Even if he were to unleash some external trade wars, the US would remain a large common market. However, if populists win decisive votes in Europe, the EU and its Common Market may fracture badly, impairing or possibly even destroying the wealth-generating machine of free commerce in Europe.

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The additional diversity and the tide of anger have already had one striking consequence in the EU. It has become ever more difficult to agree on major changes that would need to be ratified by all member 28 countries. Fortunately, European institutions still managed to rise to the challenge of the euro crisis. They created the European Stability Mechanism and set rules for conditional mutual support among the 19 euro members as the pressure of crisis had helped to concentrate minds. But it was a bruising experience. Whether similar far-reaching changes would be possible once again is an open question.

The direction of change

To some extent, the European Union has already adjusted to these forces of change.

- The EU is no longer the largely uniform club of initially six and later on 15 countries with the same rules and obligations for every member. Instead, it has evolved more into a club of clubs. 19 of its now 28 members share a currency (the euro). Most countries but not all have ceased to control passports and freight documents at internal borders in normal times (Schengen). Over time, the EU treaties have widened the scope for “enhanced cooperation” among a minimum of nine EU members.
- The European Commission in Brussels has lost part of its clout. More than before, the leaders of member countries shape the key decisions in their regular meetings (European Council). Power rests more clearly than before with those who have to answer to their national parliaments back home.
- The reform deal which UK Prime Minister David Cameron secured ahead of the Brexit referendum allows countries to clamp down on abuses of their national welfare systems while upholding the free movement of labour.

The optimal outcome

The trend towards “coalitions of the willing” seems well entrenched. The rising difficulty to get all 28 EU members to agree on and ratify substantial – and sometimes even minor – changes makes it virtually inevitable that significant new European initiatives will extend only to subsets rather than the full 28 members.

Ideally, the European Union will turn ever more into a club of clubs with a limited number of common rules for all and the freedom to form sub-groups on other aspects of policy. The mandatory requirements for all members and all sub-groups of members should be:

- the common market for goods and services, capital and labour;
- common standards for human rights and the rule of law;
- common financing of common policies through the EU budget; and
- a requirement to keep all sub-groups of countries who work more closely together on some policy areas open to all other EU members to join if they want to and meet the entry criteria.

The likely outcome

The ideal outcome, in which the current EU Common Market remains the foundation for all clubs of nations within the umbrella club EU, has one major snag: the most controversial aspect of EU membership, the free movement of labour, is one of the four founding freedoms of the EU Common Market. Further restrictions on welfare tourism may be possible. Fortunately, it seems virtually impossible that the EU could agree on and ratify actual restrictions on the rights of workers and students to work and study freely in all member states. Countries that strongly object to this principle would have to leave the EU in the end, as Britain may – but hopefully will not – decide to do on 23 June. Countries abrogating one of the fundamental freedoms of the EU would likely pay a heavy price for that, probably in terms of serious restraints on their access to the EU market for services and, possibly, for some goods as well.

The end result could thus be a much more varied Europe. Almost all countries (probably more than the current 28 as the very few potential leavers would eventually be replaced by a greater number of joiners mostly from the Balkans) would be members of an EU which upholds the four major freedoms as well as the rule of law. Some countries would remain

virtual members of this EU without having joined officially (Norway, Switzerland), enjoying all or most of the advantages of the common market while paying into the EU budget. A few further countries could form a marginalised outer ring with only partial market access (Turkey or a post-Brexit UK?).

Going forward, the most likely areas for significantly enhanced cooperation between groups of EU member states are anti-terror and internal security, including much better information sharing, and joint defence initiatives. Within the Eurozone, we may eventually see the emergence of a core club, possibly with (i) an accelerated build-up of a common deposit insurance and (ii) some joint financing of specific government expenditures (“Eurobond light”) for those members who respect some harder fiscal rules. Whereas initiatives to strengthen security and defence cooperation open for all EU members will likely be discussed shortly, forging closer ties within the Eurozone would only appear on the agenda in response to a clear and present crisis. It would not come in settled times with minimal strains and tolerable yield spreads such as those prevailing now.

The base case: reason will prevail

In democracies, major rules and institutions need a minimum level of public support. They need not adjust much to temporary fluctuations in sentiment. But one way or the other fundamental and sustained shifts in opinion will eventually express themselves in significant changes of policies and institutions.

As memories of the reasons for European integration fade, some of the ties that bind the nations of Europe together are weakening. The European Union and the euro are political projects based on the political will of their members to stay together. If we extrapolate the rise in support for right- and left-wing populists seen across the western world since the great financial crisis of 2008-2009, the EU may founder some five years from now. If so, the echoes of the nasty nationalism and destructive protectionism of the 1930s, that we can already hear in the rants of populists on both shores of the Atlantic and on both sides of the English Channel, could become more than just faint echoes.

My base case remains that this will not happen. Reason will prevail. Over the next five years, modest economic growth with continuing gains in employment and income will take the edge of the populist tide, allowing the EU to thrive again in a modified form. Let us hope that it will not take an English accident, namely that of a United Kingdom falling on hard times and possibly fracturing after having voted itself out of the Common Market, to demonstrate that it is better to stay in and reform the European Union rather than abandon this tried and tested machinery to forge compromises between nations in Europe.

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