Survival: Global Politics and Strategy
Publication details, including instructions for authors and subscription information:
http://www.tandfonline.com/loi/tsur20

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Published online: 04 Dec 2013.

To cite this article: Thomas Wright (2013) Europe's Lost Decade, Survival: Global Politics and Strategy, 55:6, 7-28, DOI: 10.1080/00396338.2013.862934

To link to this article: http://dx.doi.org/10.1080/00396338.2013.862934

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Thomas Wright

Europe's role in world affairs over the next five years will be determined more by how it has handled the euro crisis and challenges to European integration than by its external environment or bureaucratic efforts to forge a common foreign and security policy. During the past five years, analysts have concluded that Europe faces three possible futures. The euro could collapse, Europe could take a great leap towards fiscal and political integration or the continent could 'muddle through'. In 2012 and 2013, the verdict came in. It is very unlikely that the eurozone will collapse in the next few years and a major leap forward in integration is off the table. We are left with muddling through. But this third scenario has served as a catch-all to describe everything except collapse and unity. Very little work has been done to explore what it actually means. Muddling how? Through to what?

The term is something of a misnomer because it incorrectly suggests that Europe is making its way out of its predicament, however inefficiently. The evidence provides no such assurance. Based on current policy and its likely effects, we are looking at a lost European decade of economic stagnation – low growth, high unemployment, zombie banks and vulnerability to exogenous shocks – which will sap Europe's strength, heighten political tensions about the future of the eurozone and European Union, and cause Europe to play a diminished role in world affairs. To escape this scenario, Europeans must dismiss muddling through as an acceptable alternative to collapse. Instead, it should be recognised for, and treated as, what it is:

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 DOI 10.1080/00396338.2013.862934

one of two worst-case scenarios that should be avoided, if at all possible. European policymakers must consider radical steps to escape a lost decade, and the United States should assist Europe in this endeavour.

This essay explains why the greater unification and collapse scenarios have failed to materialise, and identifies the characteristics of a prolonged period of stagnation. It considers the impact of stagnation on European integration, the implications for Europe's global role and what must be done to escape a lost decade.

Neither a collapse nor a great leap forward

The events of the past two years provide compelling evidence that two frequently mentioned scenarios for the eurozone – disorderly collapse and full integration – will not come to pass, at least for the next five years.

Put simply, the eurozone has not collapsed because no member state has left it. There has not been an exit because member states in the periphery and the so-called 'core' have overwhelming incentives to oppose any such action and they collectively have the capacity to prevent it.

If a weak country were to leave the eurozone, it would encounter several major risks. Any advance notice, or even expectation, of an exit would cause a massive bank run leading to the collapse of the departing country's banking system. If the government managed to conduct the process entirely in secret or was able to establish capital controls in advance of any such expectation, those with savings in national banks would be devastated as the new currency plummeted in value. The country would have to default on its debts because they would remain denominated in euros. As a consequence, it could be locked out of international financial markets for years to come. Businesses would also fall victim to the devaluation and would likely owe money to foreign suppliers. Many would go bankrupt, thereby deepening the recession. As all of these consequences would be attributed to the government's decision to leave the euro, this is a political risk no leader would voluntarily take.

The core countries are also adamantly opposed to exits from the eurozone, but for different reasons. They worry that contagion from the collapse of a weak member state could not be contained. Creditors in the rest of

Europe would be exposed to defaults and bankruptcies in the country that left. The knock-on effect could cause bank and business failures elsewhere. Once the principle of no exits has been breached, the markets will speculate about the next country to exit, thereby putting the rest of the periphery under enormous pressure. As there is no precedent for a eurozone exit, new rules would have to be put in place to govern the redenomination of contracts. Whatever rules were established for the newly exited country would be treated by the markets as a precedent for the rest of the eurozone. Investors would act accordingly, hedging against the possibility of contagion and destabilising other economies in the process. Fragmentation of the eurozone is widely believed to pose a much greater shock to the global economy than the failure of a major private bank, such as that of Lehman Brothers. And letting Lehman fail was widely seen in Europe as an egregious error of judgement. Such exits are therefore opposed by core eurozone member states and by other major economies, including the US.

In addition to these economic incentives, all European governments have a strong political commitment to European integration and the euro which makes exit something of a taboo. The desire to keep the euro, whether because of economic or political reasons, is reflected in public opinion. A 2013 survey by the German Marshall Fund of the United States found that 60% of Europeans, and a majority in every country surveyed, said that the euro had been bad for their economies, with only 33% saying that it had been good. And yet respondents did not want to leave the euro. In Spain, 63% said the euro had been bad but 51% wanted to retain it; in France, the numbers were 64% and 57% respectively; and, in Portugal, they were 65% and 55% respectively.[1] The bottom line is that the economic and political risks of a eurozone exit are exceptionally high for its core and peripheral members. It is these risks that have prevented any departures and a consequent disorderly collapse.

Until a year ago, many believed that Europe would respond to the crisis by creating euro bonds, a full banking union, a full fiscal union and new political institutions to guarantee democratic legitimacy. This would turn the eurozone into something resembling a formal state, with a finance ministry and powerful federal tools to set fiscal and financial policy. Today, this option is off the table. There is no prospect of a full fiscal union, a European finance ministry, federal control over tax and spending, institutions to create democratic legitimacy or euro bonds. The only area in which European leaders claim to be pushing ahead with deeper integration is that of banking union, but this is grossly inadequate, does not deal with existing debt and keeps responsibility for the resolution of failed banks at the national level.

Why is a major leap forward in integration off the table? The simple answer is that it lacks sufficient support in the core and the periphery. As former member of the European Central Bank (ECB) governing board, Lorenzo Bini Smaghi, observed, we know from the past five years that the most powerful countries in Europe will only act when it is absolutely necessary to avoid disaster, and even then will only do the bare minimum.[2] For Germany, a great leap forward in integration exceeds what is perceived to be absolutely necessary right now. The country is doing relatively well in the crisis and does not believe that the system is on the brink of collapse, so there is little impetus for revolutionary change. In fact, Germans oppose such an enterprise because they would likely bear its costs. Germany and other countries are also concerned that it would be extraordinarily difficult to ratify a full fiscal and financial union. Moreover, opening up the treaty to renegotiation, which is a necessary prerequisite of a great leap forward, would create an opening for the United Kingdom to insist on a major repatriation of powers, under the threat of its exit from the EU.

Smaller countries are wary about transferring additional powers to a central authority that would be dominated by Germany. They could not reap the benefits of euro bonds and fiscal transfers while retaining their autonomy over taxation and spending. In any conceivable arrangement, this authority would move to a body dominated by core countries, especially Germany. This flies in the face of recent political trends, with economic nationalism on the rise throughout the periphery. The 2013 German Marshall Fund survey found that only 26% of European respondents, down from 40% in 2011, believe the EU should exercise control over national economic policy, while 68%, up from 55% in 2011, believe it should not.[3]

The construction of a fiscal and political union is a monumental task. In the US, it took generations. Income tax was not introduced until the ratification of the Sixteenth Amendment to the Constitution in 1913. The federal-reserve system was not created until 1913, and a fully backstopped national banking union and federal deposit insurance did not come into being until the 1930s. Some Europeans take comfort from this analogy, which purportedly shows that they are not doing too badly; in fact, the opposite lesson should be drawn. Even in America, which was a relatively young and new country, such developments took a very long time. They also involved a civil war, many state defaults up until the 1930s, a depression and much turmoil. Europe is very unlikely to accomplish this feat in the near future, particularly in the current political environment, and if it eventually does, the enterprise is unlikely to be harmonious or without cost.

Muddling through means prolonged stagnation

With both collapse and a great leap forward in integration highly unlikely, Europe appears destined for a middle path. European leaders are very keen to declare the euro crisis over. At the beginning of the year, José Manuel Barroso, president of the European Commission, declared: 'I think we can say that the existential threat against the euro has essentially been overcome.'[4] During a visit to Japan in June 2013, French President François Hollande told a delegation of the country's business leaders that

> what you need to understand here in Japan is that the crisis in Europe is over ... I believe that the crisis, far from weakening the eurozone, will strengthen it. Now, we have all the instruments of stability and solidarity. There was an improvement in the economic governance of the eurozone, we set up a banking union, we have rules on budgetary matters that allow us to be better coordinated and have a form of convergence.[5]

Similarly, President of the European Council Herman van Rompuy said that 'the euro is no longer under existential threat, financial stability has been restored, deficits have been halved, competitiveness is improving and as a result exports are picking up. Our economies will come stronger out of the crisis in the eurozone, more integrated.'[6]

Their message is simple: Europe's response may not have been pretty or all that we could wish for, but it has been effective. The continent does not need a perfect union but only some improvements on the margins – greater regulation of its banks, more fiscal coordination and a fund to help countries in trouble – to achieve the minimal level of further integration necessary for survival. Optimists take encouragement from the fact that the cost of sovereign borrowing for peripheral member states – bond yields – has come down. Ten-year bonds for Italy and Spain are less than 4.5%, compared to highs of over 7% in 2011, which is a significant reduction of the spread between their bonds and Germany's.[7] To restore growth, the individual member states must engage in structural reforms which will do for them what former Chancellor Gerhard Schröder's did for Germany in the late 1990s and 2000s. As the country's current finance minister, Wolfgang Schäuble, put it:

> The world should rejoice at the positive economic signals the eurozone is sending almost continuously these days ... What is happening turns out to be pretty much what the proponents of Europe's cool-headed crisis management predicted. The fiscal and structural repair work is paying off, laying the foundations for sustainable growth.[8]

This is the optimistic version of muddling through. It is not perfect, but it is good enough. Or so the argument goes.

This view, however, ignores several key characteristics of the approach, which appear likely to endure.

Low growth, high unemployment and a two-class eurozone

Europe's periphery is in trouble. Writing in September 2013, *Financial Times* columnist Martin Wolf noted that 'in the most recent quarter, Spain's GDP was 7.5 per cent below its pre-crisis peak; Portugal's, 7.6 per cent; Ireland's, 8.4 per cent; Italy's, 8.8 per cent; and Greece's, 23.4 per cent.'[9] Unemployment is worse, at 12% in the eurozone as a whole, 13.8% in Ireland, 16.5% in Portugal, 26.3% in Spain and 27.9% in Greece.[10] Youth unemployment in Spain and Greece is over 50%. This is in marked contrast to that in other member states. Unemployment is 4.7% in Austria and 5.3% in Germany, which also has the lowest rate (8%) of youth unemployment in Europe.[11]

Berlin advocates the troubled member states of the eurozone replicating its Schröder-era reform programme to turn around their economies. But, as Wolf has argued, parallels 'drawn by Mr Schäuble between Germany's reforms in the 2000s and the position of today's vulnerable countries are absurd.'[12] Europe's periphery countries have current-account deficits that are over six times larger, in percentage terms, than that of Germany under Schröder. They also have massive levels of debt and trouble financing themselves in the markets, whereas Germany did not.

Given Germany's current-account surplus, it is difficult to see how they could achieve export-led growth as Berlin did. After all, where would the demand come from? As Bini Smaghi writes:

> If every country became like Germany, then Germany could no longer be Germany. If countries with external deficits were the only ones to correct their payment imbalances, then demand for exports from countries running surpluses like Germany would fall. The economy of the whole eurozone would suffer without an alternative source of growth to compensate for the drop in demand from countries undergoing a fiscal adjustment.[13]

In any case, Europe's periphery is having difficulty implementing the structural reforms it needs to improve its competitiveness. Governments must take action to reform the bureaucracy, the judicial system, labour markets and infrastructure, but this often entails tackling entrenched special-interest groups. One can criticise peripheral governments for being ineffective in this respect but it does not change the fact that they are facing real political limits on what they can do.

There is little prospect of growth in peripheral countries. A prolonged period of stagnation will consolidate a two-class eurozone. The first class, which is made up of most of the core, or Northern, countries, consists of Germany, Austria, Belgium, Finland, the Netherlands and some others that enjoy relatively low levels of unemployment and debt, and modest growth. In these countries, the euro crisis will not seem too bad for ordinary citizens, despite the fact that serious risks hover in the background, such as a new banking crisis as a result of unexpected losses from slow growth. The second class consists of countries on the periphery – Greece, Ireland, Italy, Portugal and Spain – which suffer high unemployment, high emigration (especially of their most talented young people) and very low levels of growth. Unlike a two-speed Europe, in which all member states are headed in the same direction, a two-class Europe sees member states going in opposite directions. Meanwhile, there are those, like France, who are stuck in the middle, clinging to first-class status but in danger of dropping down because of rising unemployment, low growth and concerns about debt.

Zombie banks

The eurozone as a whole is afflicted by a second phenomenon that contributes to a more general stagnation: zombie banks. The eurozone's banking sector is, as former IMF official Daniel Gros put it, 'too large, has too little capital, and contains too many players that lack a viable long-term business model'.[14] In practical terms, this means that there are large parts of the banking sector that are not profitable. Ideally, these parts would be identified through robust stress tests. They would then be wound up and the banks recapitalised. But as the balance sheets of these banks are estimated to include €32 trillion in assets, or over three times the GDP of the eurozone, this is easier said than done.[15] *Financial Times* columnist Wolfgang Münchau's back-of-the-envelope estimate is that losses could be around €2.6trn.[16] With figures like this being bandied about, there is a risk that Europe's leaders will resist robust stress tests that tackle the problem head on because there is no means of recapitalising most of the banks for such massive losses. As Klaas Knot, president of the Dutch central bank, recognised, there is currently a lack of transparency about Europe's banking losses, which is a necessary, but not sufficient, condition for addressing the problem of zombie banks.[17]

This brings us on to the second problem: what Bruegel's Nicolas Véron calls banking nationalism. Véron describes this as

> the mismatch between, on the one hand, financial market integration, which is very much about banking as banks dominate credit intermediation in Europe; and, on the other hand, the fragmented nature of banking policy in Europe, which until now has remained principally in the hands of national authorities.[18]

In other words, Europe's leaders speak the language of European solidarity but act nationalistically. They adopt policies that give preference to their own banks, even if they are not systemically important. Crucially, in the eurozone's proposals for banking union, responsibility for the winding up of bad banks, like many Cypriot or Irish banks, remains at the national level. Bondholders, depositors and taxpayers will be left holding the bag before the rest of the eurozone takes a share of the burden. This reinforces the two-class Europe and dooms banks on the periphery because they are inherently less safe than those in wealthier countries.

Europe's leaders have made banking union the centrepiece of their argument for why they are on the right track, but this does not deal with the existing banking crisis and keeps responsibility for failures at the national level. The result is that the banking sector will be a drag on Europe's economy as a whole, even if no accidents occur. The real danger, however, is that the sector is a dagger aimed at the heart of Europe – one that could strike its target in the event of a new crisis. If the eurozone's banking losses are greater than anticipated, this cannot be denied for ever. A banking collapse will create a new moment of existential risk.

Germany's role and the TTIP

One could argue that stagnation on the periphery would not matter so much if Germany and other core countries were booming because the damage would be contained, but that is not the case. Germany is not suffering as badly as the periphery now, but its economic success is living on borrowed time precisely because of its policy choices. Adam Posen, president of the Peter G. Peterson Institute for International Economics, has pointed out that there are three ways for a country to improve its competitiveness: investment; increasing productivity through education and training; and cutting wages. German business, he argues, 'is competing only by reducing relative wages and moving production east'.[19] Total gross fixed investment 'has fallen steadily in Germany, from 24 per cent to less than 18 per cent of gross domestic product, since 1991' and is below that of other G7 nations. In higher education, the country fares poorly relative to others, and is not improving over time. Posen concludes that Germany's 'export obsession has distracted policy makers from recapitalising its banks, deregulating its service sector and incentivising the reallocation of capital away from old industries'.[20]

Exports therefore offer only a temporary reprieve but, as fate would have it, this strategy will be badly undermined by a two-class eurozone. Germany relies upon a healthy eurozone for its exports. As Georgetown University scholars Alexander Reisenbichler and Kimberly Morgan have observed, 'a crumbling eurozone, therefore, both threatens the very existence of the monetary union and makes the German economy dangerously dependent on demand from emerging markets.'[21] The worse the periphery becomes, the more it will pull down growth in the eurozone as a whole. There are already signs of this. Belgium, Finland and the Netherlands, all part of the German-led core of Europe, found in 2013 that they unexpectedly faced budget shortfalls and would need to adopt austerity policies of their own.[22] As demand decreases, the limits of Berlin's export model will become apparent. And, if there is a significant downturn in emerging markets, as appears possible and even likely, Germany's vulnerability will become even more acute. All the while, the danger of a weak and fragile banking system looms large in the background.

Europe will still matter, but less than it did before

Vulnerability to stagnation and a lack of demand is one reason that the EU turned to the Transatlantic Trade and Investment Partnership in 2013. The partnership seeks to create a comprehensive trade agreement between the US and the EU which reduces tariff barriers and harmonises regulations and standards on both sides of the Atlantic. It is a step in the right direction but, unfortunately, is not nearly enough to counter the forces of stagnation. According to the European Commission, the agreement is expected to add approximately 1% to the EU's GDP each year.[23] Ending stagnation will require a much more comprehensive approach, including a rebalancing of the German economy, an easing of the debt burden, a more expansionist monetary policy and the mutualisation of sovereign debt to allow countries on the periphery to invest. All of these measures are politically untenable.

The effect of economic stagnation on European integration

Stagnation – low growth, high unemployment, zombie banks and vulnerability to exogenous shocks – is not just a future scenario. It affects the eurozone now. There is very little reason to believe that the current approach, which after Angela Merkel's triumph in the recent German elections seems likely to continue, will change the dynamic. Stagnation will dramatically alter the future of European integration in several ways: a two-class eurozone will bitterly divide the EU and create multiple political crises; cause Germany to adopt a very narrow form of leadership that isolates it from the people of Europe; and increase the risk of a British exit from the EU which could set in train a period of disintegration in other countries. All the while, Europe will be sitting on several economic fault lines, especially in the banking sector, which could threaten the global economy.

The two-class eurozone created by stagnation will dramatically increase political divisions between the member states. The core countries will see little need for major change, given the short-term costs and risks associated with it, and will be relatively desensitised to hardship in the periphery. Meanwhile, governing parties in the periphery will be increasingly desperate, as they realise that the policy tools they need to escape their predicament, such as monetary policy and fiscal expansion, are controlled by the core. This will cause a widening of the divide between the core and the periphery. The periphery has not so far worked as a single bloc, as each country has tried to differentiate itself from the others in the eyes of the market. That will change as the prospect of a rapid recovery proves to be an illusion and the core fails to offer a strategy for growth in the eurozone as a whole.

Political divisions will also be exacerbated within periphery countries between parties that are reluctant to rock the boat and want to work with Germany and those in opposition who offer more radical solutions. Greece is the canary in the coal mine. Syriza, a populist party on the left of the political spectrum, came very close to winning the country's elections in June 2012. With new elections likely in the next couple of years, the party will probably come to power on a platform unilaterally rejecting the memorandum of understanding with the EU, the IMF and the ECB, causing Greece to default on its debts. This strategy, which Syriza's leader Alexis Tsipras has compared to mutually assured destruction, is designed to call Germany's bluff. As Berlin does not want Greece to leave the euro, Syriza calculates that it can do whatever it wants and Germany will not pull the trigger. Needless to say, Berlin is at pains to show that there are limits to its desire to keep the eurozone whole, and that a Greek exit may not be as catastrophic as once feared.

A dramatic standoff between Athens and Berlin is the type of crisis that will occur in a prolonged period of stagnation. Although all governments, as well as Syriza, exclude exit from the euro as a policy choice, there is a chance that it could occur by accident. If Berlin refuses to blink in the face of Syriza's demands, Greece's funding could be cut off, leading to the collapse of the country's financial system and its forced exit from the euro. Greece is by no means the only country where this could occur. It is simply first in line. The same political logic is present in other periphery states.

Narrow, isolated German leadership and a potential UK exit

Germany will be an increasingly controversial actor in Europe. German policy is correctly perceived as the key driver of stagnation. Berlin insists upon a cautious approach that emphasises structural reform, austerity, a tighter than necessary monetary policy and a banking union that does not federalise the resolution process for failed banks. With its narrow approach, Germany appears likely to play the role that the US did during the 1920s and 1930s. Instead of adopting a far-sighted strategy to stabilise Germany through debt forgiveness, the US prioritised repayment of its debts above all other matters throughout the Weimar era and even into the early years of Adolf Hitler's regime. Frequently, the debt issue was framed in moral terms. The result was that the US missed many opportunities to shape Europe's political future in a positive way, with consequences that proved to be catastrophic beyond anyone's wildest imagination.

The stakes are not as high this time. There is no danger of a government turning towards political extremism on the right or the left, although there are episodes of extremism, especially the neo-Nazi group Golden Dawn, which gained a foothold in the Greek parliament prior to a government crackdown on it for large-scale criminal activity. There is, however, a risk of a general political deterioration in the periphery that pulls it apart from the European project and produces a weakened and divided Europe. Germany appears disinterested in these developments. It is aware of them in theoretical terms but says and does very little that resonates with countries on the periphery. Berlin is not offering a vision that works for the union as a whole. If this continues, as it appears likely to, the effect will be a more powerful Germany in a much weaker Europe. On the surface, Berlin will have allies, but only because other European governments have few alternatives. However, Germany will find itself more and more isolated from the people of Europe, and this will undermine the legitimacy of its leadership.

The UK is not a member of the eurozone but is affected by the euro crisis, and the choices it makes regarding membership of the EU could deepen and prolong Europe's lost decade. British Prime Minister David Cameron has promised to hold a referendum on EU membership in 2017, after the country's next general election. Cameron's preference is to negotiate new terms of membership and win backing for them through the referendum, but, assuming that he is re-elected, it is far from certain that he will get a deal that will be widely perceived as sufficient. London has several areas of concern about its current terms of membership, some of which are directly connected to the euro crisis and the resulting uncertainty about the structure of the eurozone and the EU. These include Britain's contribution to the annual budget, which is perceived to be too high; the repatriation of powers across a wide range of areas, including labour-market rules; and the possibility that the eurozone will behave as a single entity, thereby undermining the single market and the EU. Ideally, Britain would like to remain outside of the eurozone and have a veto over major decisions taken by its members. London may get some concessions but it is unlikely to be successful in many of its demands, as these run counter to the preferences of other EU member states.

A British exit would worsen Europe's lost decade. As Tim Oliver at Johns Hopkins University has shown, the UK is home to nearly 12.5% of the EU's population, makes up almost 14.8% of its economy and contributes €11.2 billion to its budget (after the rebate). In 2011, it ran a deficit of £28bn (approximately €33.3bn) with the rest of the EU.[24] Its deficit with Germany was approximately £20bn (approximately €23.8bn) in 2012.[25] If Britain's trade with the rest of Europe is damaged as a result of its exit, the fallout will affect Germany, which relies on it as a market for German exports. Britain has been a strong advocate of pro-market policies within the EU and, if it leaves, one could expect the balance to tilt in the other direction, thereby damaging Europe's competitiveness. Britain is one of the EU's two strongest military powers. Although it would remain engaged through NATO, its departure would be a body blow to the idea of a common European foreign and security policy. Finally, Britain's exit could set in motion processes of disintegration elsewhere in Europe.

The strategic implications of a lost decade

A country's international influence rests in large part on its economic power. The EU and the eurozone are not countries, of course, but they do aspire to shaping world events as a single, unified actor. And the strength of each member state's economy is significantly dependent upon the various European systems of which they are part.

If Europe's troubles continue, it will decline as a power in world affairs, both in absolute terms and relative to others. Europe is weaker than it was five years ago, and will decline absolutely in the sense that, in five years' time, it will be even weaker. Europe is also in decline relative to the US and emerging powers, which continue to grow despite problems of their own. Absolute decline is especially debilitating in a psychological sense. Europe will continue to seek to play a constructive role in world affairs but will have fewer and less effective capabilities. Its leaders will be distracted by efforts to resolve internal crises and the people of Europe will press their governments to adopt a more narrowly drawn interpretation of national interests, which will necessitate stepping back from many costly international commitments.

There are at least five areas in which a lost decade will affect Europe's global role. The first of these is defence capabilities. If the continent has to endure a lost decade, it will be weakened on the global stage. Europe is relatively secure from existential threats and significant geopolitical challenges. Terrorism remains a problem but is more of an internal threat requiring a domestic response than an external one requiring greater power-projection capabilities that are adaptable to other environments. The Middle East is on fire but, with the exception of France and the UK, no European country has shown much appetite for shaping events there. This sense of security means that defence budgets will continue to be targeted for cuts as European governments struggle to cope with lower-than-expected revenues and continuing high levels of spending. The US now accounts for almost 75% of NATO's budget, up from 63% in 2001, and spends approximately 4.8% of its GDP on defence. In contrast, only two European countries, the UK and Greece, meet NATO's 2% of GDP target.[26] This disparity will only grow. Crucially, European nations are very unlikely to make investments in the military as long as economic stagnation persists, meaning that they may fall even further behind if technological revolutions enable other countries to take the advantage. Lip service will be paid to doing more with less through cooperation but this will be largely an illusion.

The second area is the transatlantic relationship. The demise of the transatlantic alliance is a prediction that has been made every decade since its foundation in the 1940s. A lost decade will not destroy the alliance – a close alignment of interests will still bring the US and Europe together in the face of global challenges – but it will hardly help. Instead, the US will come to realise that Europe lacks the capacity and collective will to act outside its region, even through NATO. The organisation's ability and willingness to act globally underpins US assessments of its effectiveness. If Europe experiences a lost decade, it will lose interest in projecting power and influence internationally. Leaders may try to swim against the tide of public opinion but few governments will suffer for doing less in the wider world. The clear political incentives will mean that Europe will be less likely to act alongside the US in a crisis, particularly if action is controversial and costly. The alliance will not, therefore, be the first port of call for US policymakers in a crisis. Washington invested very little time in NATO following the Syrian regime's use of chemical weapons in August 2013, mainly because German opposition ensured that there was very little prospect that the organisation would act. Instead, Washington concentrated on its bilateral relations with Paris, London and other capitals. This bilateral approach will gather steam, and most American efforts will be invested in building a productive partnership with Germany, which is seen as Europe's strongest power, on political matters. Meanwhile, the American 'pivot' to Asia will continue as US allies and partners there look to deepen and expand their relationships with Washington.

The third area is Europe's regional influence. An economically stagnant, more divided and increasingly inward-looking Europe will be a weaker actor in its region. After the Cold War, the EU was a magnet for new democracies in Central and Eastern Europe. It used membership and association agreements to incentivise liberal reform in these countries. The strategy was remarkably successful, and anchored its near abroad in the Western order. Today, the EU is trying to play a similar role in Ukraine, Serbia, the Caucasus and elsewhere. But it faces a competitor. Russia is using its economic leverage to pry some of these states away from the West. In September 2013, Armenia ended three years of negotiations with the EU on an association agreement – which would have included a trade deal – to join the Russia-dominated Eurasian Customs Union. A similar move is being debated in Ukraine. For other countries outside the sphere of a Eurasian Union, a weaker EU may cause a slide away from democratic and market reforms.

The fourth area is the effect on China and other emerging powers. The EU is China's largest trading partner, and China is the EU's second-largest trading partner, after the US.[27] Several Chinese analysts have blamed the crises in Europe and the US for China's economic slowdown. Continued stagnation in Europe would undoubtedly be a drag on China's economic prospects. In a sign of acute anxiety in China about the euro crisis, Qin Yaqing, professor at the China Foreign Affairs University, noted 'if there is a consensus amongst Chinese scholars, it is that the euro crisis, if it continues to worsen, will definitely do serious damage to China's economy.'[28] Even more important is the impact of austerity. Gros has observed that 'austerity in Europe has had a profound impact on the eurozone's current account, which has swung from a deficit of almost $100 billion in 2008 to a surplus of almost $300 billion this year.' That swing of $400bn means that 'the eurozone overall is now running the world's largest current-account surplus – exceeding even that of China.'[29] This has driven the deterioration of emerging powers' current accounts and damaged their economic prospects. The silver lining, from China's perspective, is that weakness in the West may give it an opportunity to increase its influence in international institutions at Europe's expense. This will be cold comfort, however, if the price is an economic downturn of its own.

The final area is the liberal international order. Europe's crisis undermines one of the great success stories of the liberal international order. For decades, the EU was a model for others to follow. Now, it serves as a warning that will reduce the incentives for integration and cooperation elsewhere in the world, including in Asia. Beyond its borders, Europe has acted to support and strengthen the liberal international order that encompasses the global economy, security alliances, institutions, norms and rules. It will still endeavour to do this in a period of stagnation but will be much less effective than it was. Economically, Europe's troubles are likely to prevent the rest of the world from turning the page on the financial crisis. The continuing vulnerability of the European banking sector is a significant fault line in the global economy that could precipitate a new shock. With respect to security, Europe will play less of a role in upholding international norms and rules, particularly if this involves the projection of military power. Key European objectives, such as the revival of climate-change negotiations, are unlikely to go very far.

A lost decade will not be a calamity for European influence internationally. It is unlikely to lead to a great-power war, as in the 1930s, or to a full-scale collapse. However, there will be a significant cost attached to it. Europe will slowly but surely lose influence in a wide range of areas as it declines in absolute and relative terms. Europe will still matter, but less than it did before, and the rest of the world will increasingly look to bilateral relationships with countries that can offer support for specific goals – Germany on economics and the UK or France on defence. The analysis here is only a baseline scenario. Unexpected crises, internal or external, could result in a more dramatic descent. This makes it all the more important to find a way out.

Averting a lost decade

Richard Haass' recent book, *Foreign Policy Begins At Home*, argues that America's greatest challenge is domestic. Whether that is true is debatable. But the idea clearly applies to Europe. Based on the first four years of the crisis, the EU as a whole has performed worse than Japan did during its lost decade. Between 1991 and 1995, Japanese GDP grew by 1.9% in real terms, compared to a 0.2% decline in GDP in the eurozone between 2008 and 2012.[30]

Unemployment was very low in Japan, never exceeding 5% between 1991 and 2001, whereas it is much higher in Europe – 12% for the eurozone as a whole but over 25% for several countries.[31] It would be one thing if this could be attributed to a temporary drop after the financial crisis and a bounce back were imminent, but the choices Europe made after 2008–09 mean that the stagnation will deepen further and last for some time. In a way, a lost decade may be a best-case scenario. After all, five years have already passed. More worryingly, the stagnation could last well beyond the ten-year mark, as it has in Japan. Every year of stagnation will badly damage European integration and Europe's role in the world.

To escape a lost decade, Europe needs a growth strategy above all else. It currently lacks one. The eurozone is still deleveraging after the financial crisis. Governments that do not have a debt problem refuse to borrow to invest, even with historically low interest rates. Companies and households with access to cheap money also refuse to borrow – in Germany, both started saving after the dot-com bubble and have not stopped since.[32] On the periphery, where businesses and households may want to borrow, credit is expensive so they cannot find funding. The result is an enormous eurozone surplus, a dearth of demand and growth and the prospect of deflation. This is a disaster for Europe but it is also very stable. Europe's great challenge is to break out of this suboptimal equilibrium. It has to take greater risks for growth. Only one country, Germany, has the capacity to lead this effort.

Berlin should run down its surplus, increase government investment and introduce additional policies designed to kick-start German consumption and spending.

The eurozone also needs to fix its banking system. If the periphery does not have a functioning credit system, it cannot grow or return to low levels of unemployment. This means tackling legacy debts in the banks and truly delinking the banks from the sovereign. Monetary policy also has an important role to play. The ECB has massively undershot its inflation target of 2% – current projections show it will only reach 0.7% in the eurozone in 2013.[33] It must undertake policies to reach the 2% target and should then increase it to 3% or even 4%.

In terms of political and fiscal union, the eurozone needs strong German leadership but it also needs this leadership to be exercised in a way that is perceived by the peoples of Europe to be in their collective long-term interest. There is great scepticism in the rest of the eurozone that Germany's reliance on its own experience with structural reform and austerity in the early 2000s will solve today's crisis. This is undermining German leadership and is creating a dangerous division between Germany and other eurozone member states. If Berlin were to endorse a strong pro-growth economic policy, it would be more palatable to the rest of Europe and would ensure that German leadership was seen as constructive rather than as an unwelcome imposition.

The quid pro quo for Germany would be the continuation of politically difficult structural reforms, which benefit economic competitiveness but are unlikely to be sufficient on their own. The country will also benefit considerably from the legitimation of its leadership role and the revival of European integration. There is no doubt that this asks a lot of Germany. It has come in for a lot of criticism but is only acting in accordance with its own interest and economic beliefs, as almost all countries do. But Germany has a proud post-war tradition of adopting a more enlightened notion of its interest which works to the benefit of Europe as a whole. A change of course in the name of European integration would be consistent with this tradition. A recent, far-reaching proposal by eleven leading German economists, political scientists and lawyers for a new European treaty and greater efforts to increase demand is one example of what such a shift in German policy might look like.[34]

To maintain their global influence, European governments should adopt a counter-cyclical foreign policy that deepens their engagement in world affairs even as they are incentivised to withdraw from them. This would include recommitting to the transatlantic alliance, deepening the EU's engagement in Asia, taking a proactive role in the Middle East and North Africa and abandoning further defence cuts. European nations are still very wealthy societies and they can choose to bolster their influence in a recession if they wish. This will not fully compensate for the geopolitical risks of economic stagnation but it should buy Europe some time.

All of this will be extremely difficult to do. The politics that are driving stagnation – in Germany, France, Britain and the periphery – seem to be set in stone for at least the next four years. For this reason, Europe appears unlikely to escape its lost decade, but an exit strategy does exist if European leaders decide to look for it.

Acknowledgements

The author would like to thank Kemal Dervis, Fiona Hill, Robert Keane, Steven Pifer, Antoine de Saint Phalle and Jeremy Shapiro for commenting on earlier drafts of this article.

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