EUROPE'S WINTER OF DISCONTENT

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EUROPE
DOSSIER
IN CRISIS

Europe's worst crisis since the Second World War is multilayered. On the surface, it is about excessive sovereign debt. There is an underlying lack of confidence on the part of financial markets that sufficient solidarity exists in the EU to back up the common currency by easing the short-term debt burdens of the most over-extended Euro-members. However, its roots are in political shortsightedness and institutional flaws that were in the European project's origins, when national parliaments retained the exclusive prerogative to tax and spend, which resulted in widely varying fiscal policies and financial conditions undermining the common currency. A Euro-skeptical British government disagrees with the proposed EU Treaty changes to mandate closer integration. The critical issue is whether the political leadership, especially Germany's, is there to support the common currency and defend the EU's future.

La pire crise européenne depuis la Seconde Guerre mondiale a de multiples causes. En surface, il y a le niveau excessif de la dette souveraine, dont résulte la perte de confiance des marchés financiers. Mais elle a son origine dans une politique à courte vue et des défaillances institutionnelles qui ont limité le projet européen dès ses débuts, quand on a laissé aux parlementaires de chaque pays la prérogative exclusive de taxer et de dépenser. Résultat : des politiques fiscales et des situations financières dont l'extrême variation érode la devise commune. Face à l'euroscepticisme d'un gouvernement britannique qui désapprouve les modifications proposées au traité de l'Union européenne et donc une intégration plus poussée, c'est la capacité du leadership politique, notamment allemand, de soutenir la devise et d'assurer l'avenir de l'Union qui constitue l'enjeu clé.

Proposals for a European union have been preoccupying European minds since the Second World War. Remember William Wyler's classic 1953 film *Roman Holiday?* Princess Anne (Audrey Hepburn in her US debut), heiress to a prominent European throne, has to face the assembled foreign press corps. The first question expected is "What do you think of the idea of European federation?"

After more than half a century of effort to create an "ever-closer union," polls show that many Europeans think less well of the idea than they used to.

The year 2011 saw what German Chancellor Angela Merkel and French President Nicolas Sarkozy termed the gravest crisis Europeans, and the EU, have faced since the Second World War. And it is far from over. Indeed, in her New Year's message Chancellor Merkel warned fellow Germans that 2012 will "undoubtedly" be even "harsher."

The crisis began as a sovereign credit crunch flowing from fiscal indiscipline that exploited regulatory weakness — the absence of mechanisms to insure fiscal consistency among euro-zone members. It was aggravated by the downturn in public and market confidence caused by the 2008 financial meltdown. In 2011 it grew into a multilayered political crisis in EU governance and institutions.

Already on June 28, 2011, an editorial in the *New York Times* judged the survival of the euro to be in "serious doubt." Summer and fall deepened the crisis as Greece's trajectory toward default of sovereign debt hardened, with ominous implications for other heavily debt-burdened Euro-zone members Portugal, Spain, Ireland and, perilously, even Italy.

Whether the European Union, and especially the 17 euro-zone members, can repair the situation and stabilize the euro is a globally important issue. The EU accounts for 20 percent of global GDP, and the euro represents 26 percent of world currency reserves. The major reason, though, is that austerity programs needed to reduce deficits threaten a sharp European recession. Although the EU market accounts for only about 8.5 percent of sales of Standard & Poor's 500-firm US Index, a European recession would still have a direct economic and hence political impact on the US, where a still-fragile recovery is taking root.

After the European Summit of December 8-9 failed to reach consensus on a definitive solution for the euro and restore confidence in the whole European project, North American opinion, taking a lead from UK media, darkened. Various pundits judged it inevitable and natural that national European identities reassert their superiority over artificially induced notions of a common European home and project. Margaret Thatcher's view that the common currency was "bound to fail" without much closer fiscal and financial union — which she and the UK have always considered repellent — is regularly cited by those whose belief systems do not extend to the project of a common European home.

How much of this is inbuilt British Euro-skepticism? Is it politically impossible for Europeans to get their act together in time? What has to be done? And how did all this come to pass?

The December summit had met to consider a Franco-German proposal to amend the Lisbon Treaty (2009), which frames the union's powers. The amendment would have repaired the basic flaw in governance surrounding the euro's creation a decade ago by at last mandating obligatory fiscal coordination among euro-zone members and enforced and intrusive scrutiny of budgetary expenditure and practice (to avoid repetition of false reporting as happened with Greece), as well as a financial transactions tax.

The tax itself is modest, 1/10 of 1 percent on all transactions between institutions, and after implementation in 2014 could raise as much as $74 billion a year for a virtual common treasury. But the UK sought special safeguards to protect its financial services sector.

The issue should not have been intractable, but most other EU members were generally fed up with years of euro-derision from British representatives and turned down the British asks. The British then vetoed the proposal to amend the Lisbon Treaty, which required unanimity. The other EU members decided to proceed with the necessary arrangements via a treaty just among themselves. This step isolated Britain on the margin of Europe as never before since UK entry into the European Economic Community in 1972.

As the name-calling and blame games began across the heavily polarized landscape, Euro-skeptics took the lead in UK and North American news outlets. Roiled and skittish financial markets reacted and overreacted to each new twist in the crisis, outstripping the ability of European leadership to catch up. The commentariat, particularly in the Anglo sphere, ventured beyond predicting the euro would break up as a common currency and pondered the end of the European Union itself.

As Paul Krugman chided, demonstrable failure to resolve the crisis was "killing the European dream" as public opinion grew ever more despondent.

National myths and phobias dumped more fuel on the flames of the political psychodrama, especially after the December showdown separated Britain from the rest of Europe, seemingly because of a new German national assertiveness evoking recollections of 1945 that often seemed from a skit from *Monty Python* or *Fawlty Towers*. In all of this, few looked beyond institutions and techniques to explore the human and political roots of the crisis and issues of belief and confidence in political will and abilities.

To understand it all, we do need some history. It might also help to consult warnings from Nobel Prize-winning psychologist Daniel Kahneman, from his recent study, *Thinking, Fast and Slow*.

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More than 40 years ago, Kahneman brought psychology as a discipline out of the realm of subjective and even intuitive interpretation into evidence-based analysis. Some of his findings identify how "confirmation bias" and the "halo effect" (or negative halos) induce people to seek intuitive confirmation of prior bias. He assesses how judgment is skewed by "peak-end" experience ("What you see is all there is" or "WYSIATI"), at the expense of longer-term assessment. Kahneman writes too of how "the negative trumps the positive in many ways" via "loss aversion." Such cognitive illusions are all discernible in the way long-standing likes and dislikes govern beliefs about the EU, pro and con, and in views of its future, particularly in the media.

Beliefs are affected by age, memory, and experience. (Kahneman also analyzes the inherent conflict between the "remembering self" and the "experiencing self.")

The European project was always existentially intended as a political one, emerging from the world wars of the first half of the 20th century. Jean Monnet's insight in advocating the creation of the forerunner Coal and Steel Community was that functional cooperation and interdependence would bind the nations politically, especially France and Germany, and thereby end Europe's murderous wars forever.

The project for an "ever-closer union" succeeded the devastation of the Second World War, but its founders were also survivors of the 1914-18 war. As a student in Paris in the early 1960s, I encountered the enduring impact on older French citizens of the country's earlier trauma. How I wished in recent years that idiotic neo-conservative Iraq war hawks who labelled the French as "surrender monkeys" could be forced to walk through the graves of the Somme and Verdun.

What cause could be nobler than ending those murderous wars forever? Churchill embraced it from the start,

CP photo

German Chancellor Angela Merkel and French President Nicolas Sarkozy at the European Summit in December. Germany and France are leading efforts to bolster the European project.

calling for a "United States of Europe" as early as 1946. When I first worked in Brussels in 1968, the strength of that cause was almost spiritual among officials at the start-up European Commission who had experienced the costs of the Second World War firsthand. (What remains of that spirit in the quarrelsome EU bureaucracy today?)

And yet British and continental European experiences were inherently different. Continental countries that had lived through defeat, harsh occupation, vast destruction and even national shame emerged from 1945 in different psychological condition from Britain, whose self-esteem in 1945 was at a historic high. Such differences became part of the fabric of national self-concepts, which play out even now.

Jean Monnet's functional approach to building a new Europe led to the Messina Conference and the 1957 Treaty of Rome, which established a common market for the original six western European members — France, Germany, Italy and Benelux — and "an ever-closer union" of the peoples whose leaders signed it.

The "economic miracle" of postwar recovery is by now almost legendary, the years the French call the *trente glorieuses*, lasting until the recession and the oil shock of the 1970s.

Democracy was secured even though, as today, it sometimes seemed dysfunctional, with a merry-go-round of short-lived governments, especially in France and Italy. But a political consensus emerged around a "European social model" with an abundance of publicly financed social services and safety nets.

Monnet and the other founders of the European project had chosen a functional approach for a reason. While they aimed to contain forever the competing nationalisms of nation-states, they were very wary of making a frontal assault on national sovereignty and underlying identities, even if what they had in mind would be the greatest voluntary pooling of sovereignty in history. By limiting active integration to specific functions, they finessed the political issues. But by finessing politics in favour of a nontransparent bureaucratic process, they inadvertently ensured the project would be elitist and technical.

Fatally pertinent to the crisis today was the bedrock decision to retain in the exclusive control of national parliaments all powers to tax and spend. The Common Market, which led to the European Economic Community, was not an economic union but only a cooperative of sovereign states whose leaders answered to their own parliaments and electorates. Ever conscious of re-election, they made sure to retain all the instruments of national budgetary prerogative, including economic incentive and reward, essential for their political ambitions. Thus were sown the seeds of sovereign extravagance and debt in several national jurisdictions.

Meanwhile, increasing prosperity numbed Europeans to the fact the European project undertaken in their name was in practice a bureaucratic one, detached from popular connections.

Britain was initially ambivalent about the European project, not wishing to be excluded, but also wishing to avoid very ambitious commitments. Burke Trend, later British cabinet secretary, in the final briefing for ministers prior to the Messina Conference, which in 1955 launched the process that would lead two years later to the Treaty of Rome and the Common Market, advised the cabinet that it would "on balance be in the real and ultimate interest of the United Kingdom that the Common Market should collapse, with the merit that there would be no need for the UK to face the embarrassing choice of joining it or abstaining from joining it."

But the UK did apply in 1961, an application that President Charles de Gaulle famously vetoed.

It has been a long-held belief he did so primarily because he saw the British as the *cheval de Troie* of the United States. His treatment by US and UK wartime leaders loath to acknowledge his claim to be the unrivalled leader of the "Free French" had convinced de Gaulle not to trust the "Anglo-Saxons," who in his mind were European rivals. For de Gaulle, a new Europe would offer an alternative vision to Anglo-American laisser-faire economic "liberalism."

But paradoxically, de Gaulle, a cultural nationalist, also had a concept of a *Europe des états*, which would resist supranational inroads on French sovereignty.

By the time the UK was readying another application to join the EEC in 1969, de Gaulle confided in the UK ambassador to France Sir Christopher Soames that he saw Britain as a potential French ally in seeking for Europe "a broader, though looser construct, with more members and wider tasks, yet liberated from some of the supra-national pretensions and invasions of national sovereignty." De Gaulle resigned not long afterward, but Gaullist reservations about political integration persist in Nicolas Sarkozy's positions today.

Britain negotiated the terms of UK entry by 1972. This time, Canada supported the realism of British acceptance of its European vocation, hoping to lever through old imperial and Commonwealth ties to London a more favoured, wider Canada-EEC economic relationship, an aspiration the British never really shared, in practice. The UK focused on the need to use national political capital to influence the EEC in British interests, which included limiting the European project's reach over national prerogative. Their view of the European project was limited and strictly functional and, in this sense, it was really quite Gaullist in spirit.

In 1975, the British public voted two to one against the UK withdrawing from the EEC in a referendum launched by the new and ambivalent Labour government, which succeeded the UK's only out-and-out pro-European prime minister, Conservative Edward Heath. But public support was in reality tepid. The late Hugo Young, the much missed *Guardian* political columnist who chronicled the UK-Europe saga in his massively impressive *This Blessed Plot,* judged that "the UK political class failed to convey, perhaps even to experience, a sense of idealism about the project."

Why did the European flame never really catch when it crossed the Channel to Britain?

De Gaulle's assessment that the British were chronically conflicted over their attraction to the United States was certainly a factor, especially under Margaret Thatcher. Her successor as prime minister, John Major, acknowledged as much to Young: "Unlike any other European nation, we are genuinely split as to where our interests lie." Major, who, unlike Thatcher, became convinced in office that the UK had to be at the "heart of Europe" and who suffered a Conservative Party revolt in consequence, nonetheless believed Britain would be "mad to choose" between the two fundamental vocations, a belief frequently echoed by his successor, Tony Blair, whose fateful choice to support George W. Bush in the invasion of Iraq would in fact sever the European Union politically in two.

But British antipathy to ever-closer integration of the members of the EEC and its successor the European Union was over much more than its presumed "special relationship" with the US (a presumption of exclusivity shared by many other countries, including Canada).

There has always been an authentic and ferocious wish, at least on the part of the political class, to preserve the autonomy of the Westminster Parliament and especially the prerogative of being its own master in matters of taxation and expenditure.

Some of this fervour is bound up in the idea of Britain as an original hothouse of freedom, that Westminster is the "mother of parliaments," a shibboleth that took on greater resonance once Margaret Thatcher began to dismantle the UK's welfare state and implant a laisser-faire style to economic governance the Conservative Party at least began to claim as intrinsically British.

By 1988 she apprehended the apparent fact that "ever-closer union" was actually being taken sufficiently seriously across the Channel to be a threat to what she had done to transform Britain. "We have not successfully rolled back the frontiers of the state in Britain only to see them re-imposed at a European level,

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with a European super-state exercising a new dominance from Brussels," she intoned at the College of Europe.

Sir Geoffrey Howe, whose resignation as foreign secretary over Thatcher's hostility to the European project launched the open rebellion in the party that brought her down in 1990, judged that this was when "she ceased to allow her head to rule her heart."

Although Thatcher had major objections to what was transpiring in Brussels, and sought and received budgetary rebates from the costs of programs from which the UK opted out, few contested 20 years ago the European project's apparent success on many important levels.

But her heart captured the spirit of many of her generation in England whose formative views on Britain, Europe and especially Germany emerged from wartime. As Hugo Young put it, "The images fixed by Hitlerism extended into a picture of Germany as an expansionary power out to dominate by peaceful means the Europe it had almost destroyed by war." In her last year as prime minister, Margaret Thatcher would be a Western hold-out on German reunification. Young was writing more than a decade ago, but his description captures some of the retro-reflexes replicated today by the media in several European capitals over Chancellor Merkel and German domination of the Euro files.

But in the end, the most plausible explanation for British standoffishness to the European project probably inhabits the bigger legacy of received history, specifically as defined by the English.

Historians such as (Welshman) Norman Davies identify "a mental framework that simply could not conceive of a world that did not place the greatest country, occupying a fourth of the globe, at its centre." Henry VIII had, moreover, made the Channel a barrier behind which England felt shielded from the Continent's Catholic powers and culture. As Young described, "Since the reformation, the English have had little choice but to take pride in their isolation and eccentricity."

Five million Scots have another view, of course, of their place in Britain and also in Europe, but until the advent of the Scottish National Party, now with a majority in Scotland's Parliament, their angle was more or less outside the lens of popular English history.

Whatever the underlying reasons, it is no wonder that when David Cameron said no to the Merkel-Sarkozy proposal to amend the EU Treaty in December, which Chancellor Merkel intended to "right the mistakes of the euro's birth," 58 percent of the UK population supported his "standing up for Britain," with only 21 percent opposing the use of the veto, though some of them saw "an act of self-defeating crass stupidity…rarely equalled in British foreign policy" (the *Guardian*). As for Britain's partners, Polish Foreign Minister Radoslav Sikorski, who led an increasingly impressive Polish EU presidency, captured their general bafflement over "the satisfaction Britain has once again become an island."

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The arrival in 1985 of an extremely able and high-profile president of the European Commission, Jacques Delors, ushered in a period of enormous accomplishment in momentum toward the "ever-closer Union." The single market was completed and would extend beyond trade in goods to services, capital and, via the Schengen agreements, the free movement of people. In 1990, the Maastricht Treaty (adopted in 1993) pointed the European project toward historically ambitious new frontiers, anticipating monetary union and across-the-board strengthening of the powers of what would be the European Union — in common foreign policy, a common external border and strengthened institutions.

An enlargement process was set in motion to admit as EU members newly democratic applicants from among the former members of the defunct Warsaw Pact and the former Yugoslavia.

Meanwhile, EU economic growth proceeded, though at a slower pace from the "Golden Age" of 1950 to 1973. By the 1990s, Europeans were convinced they had never been so prosperous, healthy, free or green in their history.

But other contrary trends were developing. Unemployment increased fourfold to 8 percent, and ominously, public deficits rose from averages of less than 2 percent of GDP in the 1950s and 1960s to 6 percent after the oil shock and recession of 1973.

Demographically, Europe was aging. Dependency ratios between those actually working and those receiving pensions — generally state-financed — were being stretched way beyond actuarial projections made when the generous social service and pension models were being put in place. The pension outflows would reach unsustainable levels by 2000: 17 percent of the Italian budget and 12 percent of Germany's (compared to 5.6 percent in North America and the UK).

Moreover, the faces of many European cities were changing demographically. Officially, EU members had opted for "zero immigration." But this only meant that they were not actively recruiting new immigrants for permanent settlement as new citizens in the way a diminishing number of countries (basically Canada, the US, Australia and New Zealand) continue to do.

Nonetheless, still open to refugee claims, countries of the European Union continued to receive waves of asylum-seekers from the broken parts of eastern and Southern Europe and economically deprived zones of Africa and South Asia. They also took in temporary workers — most famously Turkish guest workers (*gastarbeiters*) to whom Germany extended few of the rights of citizens — thereby creating a parallel foreign society within. The point is that they did not choose their millions of refugees and guest workers and had few programs in place to assist their integration.

We know what happened over the course of the decades. It is easy to criticize local reaction against newcomers. But when three generations of effort by Danish women to obtain the world's most complete gender equality were challenged by the influx of refugees whose traditions and behaviour seemed to relegate women to inferior status, a hostile reaction becomes understandable — as it does in the case of the Dutch, whose national experience over three centuries of religious conflict resulting in a complete separation of church and state had to confront "newcomers" insisting on Sharia law.

As time went on, and numbers only increased, radical right-wing populist anti-immigration parties grew like mushrooms: the Front National in France, the Northern League in Italy, Vlaams Belang in Belgium, Geert Wilders in Holland, the True Finn and Danish People's parties. Only Germany seemed immune, at least on the surface.

The advent of jihadist terrorism accelerated the appeal of these identity-based populists. The facts are that Muslims constitute only 3 percent of European populations and, despite sensationalist claims to the contrary, will stay between 5 and 8 percent by 2025. But popular prejudice is what it is.

For the EU, it was ominous because over time the identity-based parties became as anti-EU and anti-Brussels as they were anti-immigrant.

Too many politicians, especially on the centre-right, helped ensure the crisis of confidence today when, to stem the leakage of voter support, they began themselves to pander to anti-EU sentiment. As was said about Jacques Chirac after the No side won the referendum on extending the EU's powers in 2005, "You can't defame Brussels politically from Monday through Saturday and then expect on Sunday to win a referendum on a bigger and deeper EU."

This tendency of nationally elected politicians to run against "Brussels" was even more corrosive to shared purpose when it came to national finances because of the original design defect that kept all tax and spend powers in national parliaments.

The Stability and Growth Pact of 1997, which prepared for the common currency, intended to hold budgetary deficits to 3 percent of GDP and overall sovereign debt to 60 percent. But the bias against intruding on the prerogatives of national parliaments and politicians prevailed, and the intention remained essentially self-policing. Former Italian prime minister Romano Prodi points out that there was always a background realization that a common currency would need common attentiveness to fiscal discipline, but the hope was that the EU, still hobbled by sovereignty inhibitions, would "grow" into it in time.

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In 2002-3, after the euro had been launched, Germany and France both ignored the limits without sanction, thereby giving a tacit green light to smaller EU countries, especially those in the south, using lower euro interest rates for borrowing to fuel debt-financed consumerism. Their economies fell way behind the north in productivity, exports and current account balances, but their spending sprees carried on with no centralized control over behaviour.

Most European economies had other debilitating structural flaws. Except for Germany and the north, nonsalary wage costs meant to finance social protection inhibited labour mobility, productivity and growth. But changing the tax codes was a political risk.

Even more unpopular were measures to bring state-financed pensions closer into line with affordability. "We all know what we have to do," quipped the Prime Minister of Luxembourg, Jean-Claude Juncker. "The problem is getting re-elected afterward."

Millennium skies were darkening, and Jacques Delors was missed by some, but not all. Some major members preferred the noncompetitive comfort of a less assertive chief of the Commission. The EU chose a passive minor figure as his successor, Jacques Santer of Luxembourg, whose truncated tenure became an embarrassment. At one point, the full European Commission had to resign because of episodes of abuse of privilege.

The tendency to choose mediocrity for the sake of egos in member state capitals goes on today. Over the years, the EU had been trying to build credibility for a common foreign policy mandated by the Maastricht Treaty, especially under a leadership partnership of effective international stars such as the EU high representative and UK commissioner, respectively former NATO secretary-general Javier Solana and Chris Patten. But after the Lisbon Treaty combined the two jobs, the division of spoils by competitive ministers in capitals and UK prime minister Gordon Brown's EU cynicism combined to deal the vitally important position to a Labour Party stalwart, Baronness Catherine Ashton, who had little relevant international experience or profile. She has struggled. Late last year, in buyers' remorse, 12 EU foreign ministers formally complained

PMO photo

British Prime Minister David Cameron, here with Canadian Prime Minister Stephen Harper at a news conference in the garden of 10 Downing Street in June 2010, refused to join his European partners in a financial restructuring because of costs to the UK financial services industry.

about her nonperformance. But they had gone along with her selection.

In any case, the credibility of EU foreign policy had already been ruptured by the UK-supported US invasion of Iraq in 2003, which split the EU between on the one hand most of "old Europe" and on the other newer EU adherents from behind the Iron Curtain whose world views were more attuned to strategic directions in Washington than in Brussels where they felt their interests to be under-appreciated.

The further enlargement of the European Union was meant to be an unequivocal good news story but it seemed to pile the pressure of more change onto increasingly stressed citizens. Western Europeans pushed back at its pace and breadth. Many in the countries that entered in 2004 were themselves resentful at conditions of entry imposed by the older members and disappointed in lack of delivery of a better life from their democratically elected governments, a trend that continues today. A European Bank for Reconstruction and Development (EBRD) survey shows a sharp drop in new EU countries in support for democracy, with Hungary today actually subtracting from democratic space. Meanwhile, while enlargement had for some in Western Europe seemed to undermine the European project's homogeneity of purpose, some strong EU advocates such as the Polish government of Donald Tusk wondered about the quality of Western European leadership.

After the proposal for a new European Union constitution was defeated in referenda in France and then in the Netherlands in 2005, a more modest and digestible proposal eventually won approval and ratification as the Treaty of Lisbon. But the citizens of Europe were no longer reverential about the original dream. They had long taken for granted its historic achievements of peace and felt entitled to standards of living they expected would continue spontaneously to rise.

The 2008 economic/financial meltdown burst easy-money speculative bubbles, notably over property in Spain and Ireland, which hastened the crisis in sovereign debt and also private credit. Forensic evidence exposed long-standing systemic tax evasion in several countries, which contributed to a further deterioration of solidarity between northern and southern Europe.

Debasement of the EU brand accompanied a descent that occurred because of the effect of events on decades of politically inspired deception by Europe's elected politicians from the member states themselves. Instead of competing electorally on platforms that reminded citizens how much the EU had accomplished, they blamed Brussels for any hardship.

In Britain, discussion of European affairs had taken on a phobic edge with the right wing of the Conservative Party increasingly insisting on repatriation of various powers previously extended. Liberal Democratic coalition partners have been vociferous in support for EU engagement but their public standing is slipping.

More surprising is evidence of collective delusion in Germany. Though the EU's biggest member and strongest economy, with a robust democratic political culture, Germany has been reluctant to lead. Commentators even speak of a "hollowing out of commitment" to the European project.

An example cited is Germany's abstention on the UN Security Council's vote in May to authorize on humanitarian grounds the no-fly zone over Libya, whose principal backers were France and the UK. It was an important opportunity for European unity and leadership on foreign policy that was undercut, though there is some understanding why Germans might have national reticence over endorsing military intervention.

But on the debt crisis, German reticence cannot be an option. Decisive German leadership is essential to an effective outcome. Radek Sikorski observed to Poland's neighbours: "I fear German power less than I am beginning to fear German inactivity. You have become the indispensable nation."

From the start of the year Chancellor Merkel has been active in calling for much closer economic and fiscal policy integration among euro-zone members. But she has been very reluctant to authorize the European Central Bank (ECB) to stand behind the euro by buying up sovereign debt of over-extended member treasuries, presumably because she is deferring to German public opinion, which remains divided over the euro's benefits.

Critics charge the Chancellor with failing to explain the value to Germany of the whole euro project so that public opinion would rally behind leadership by Germany that was more convincingly strategic.

The facts are emphatic: Germany has been the euro's greatest beneficiary and it is time for the Chancellor to say so and behave accordingly.

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The German phobia over inflation is well known but hardly more valid today than remembered experience from wartime Britain. Since the introduction of the euro, inflation has been at 1.6 percent a year compared to 2.6 percent over the prior life of the modern Deutschmark. The euro itself was launched as a trading currency in 1999 at US$1.18. Today it is at US$1.29 (having been as high as US$1.46).

The common currency underpins the single market. German exports to EU partners are up 9 percent a year since the euro took effect, as opposed to a 3 percent annual increase beforehand. Exports to the 10 countries that joined after 2004 are up from €115 billion in 2004 to €95 billion today. That export performance means that German unemployment is now the lowest since reunification 20 years ago.

Some opinion in Germany chides "Club Med" EU members for negative current account and trade balances as if the EU were like Garrison Keillor's Lake Wobegone where "all the kids are above average." A customs union doesn't work that way, and Germans have the jobs less competitive Southerners lack, whatever their fiscal irresponsibility.

The first months of 2012 will see critical euro-zone meetings that will look to the German Chancellor for leadership.

What must be done?

First, to assess a crisis that is "primarily about confidence and credibility" (Sikorski again), analysis should relativize the overall debt situation.

Average annual fiscal deficit in the euro-zone is 4.7 percent, too high, but much less than the 10 percent of the US (or the UK's 9 percent). Cumulative sovereign indebtedness is an average of 80 percent in the euro-zone (82 percent of GDP in France and 75 percent in the UK), about the same as Canada's and less than 100 percent for the US and almost 200 percent for Japan.

The problem, obviously, is not the average situation but the unevenness of situation. The financial markets that fix interest rates for debt service do not calibrate their probably over-pessimistic fears to averages, but to the weaker specific debtor countries whose bonds are being priced.

The solution is to give markets every sign that solidarity will apply. Creditor euro-zone members must together stand behind the debt of other euro-zone members. The markets have doubted that politicians will agree to do so in full force.

Crucial decisions need to follow up on the first steps taken at the December EU summit when Chancellor Merkel and President Sarkozy advanced the long-term solution of a new constitution for Euro- countries at least to create a centralized fiscal and regulatory authority backed by the European Court of Justice for enforcement, all necessities for a common currency. This comes with a corresponding amount of political integration. France has its Gaullist reservations but will have to get over them.

Germany in return will have to get over its reservations on the *short-term* issue of central bank support for sovereign debt. Chancellor Merkel has until now (mid-January) argued that it is up to individual countries to act individually. She continues to resist an expansive interpretation of the ECB Charter, which would permit it to buy on behalf of all euro-members the sovereign debt of member countries with backs to the default wall, in large part because of reluctance to take the heat off Italy in particular. Italian Prime Minister Mario Monti seems to get it, pledging budgetary measures to get Italy back on fiscal track.

There will need to be hard-headed assessments, especially in Greece, as to whether sovereign default is not in fact inevitable. Some banks might need to accept bankruptcy as well. The ECB did inject about €500 billion into the private banking system in December by providing three-year loans at 1 percent, enabling banks to repay more expansive one-year loans made available earlier and thereby stay in business. But are banks lending the new liquidity out?

These issues will come to the fore over the first quarter of 2012, when a large amount of European sovereign debt will come due. Without market confidence, interest rates at which the debt is refinanced will add to the costs of austerity being asked of euro-zone members trying to exit chronic excessive deficit.

Many economists argue that budgetary austerity is already cutting off the chance of recovery, which only deepens the revenue shortfalls and the overall endemic indebtedness.

Making austerity smart enough not to snuff out growth is important, though it probably means cuts to defence budgets. That will dismay the US, which pays 75 percent of NATO's costs.

Realistically, Germany should relax about inflation in the euro-zone going up to a still modest level of 2 to 3 percent rather than 1 percent to soften the impact of austerity. German salaries will rise.

But the most important ingredient is political leadership that will instill confidence and tell voters what they need to hear, not what they want to hear. Facing up to doing the right thing may not be a route to re-election as prime ministers José Luis Zapatero and George Papandreou (and involuntarily Silvio Berlusconi) discovered, but national leaders in conscience need to do it. The way to deal with Front National leader Marine Le Pen's call for France to exit the euro is not to pander to her voters' bias but to defend the Euro and the need for "more Europe," not less.

It is time for European leaders to save the historic European project by telling the truth: that the European Union and the euro are as essential as ever to the well-being of Europeans.

To "be European" is more than a question of currency and technique. It involves solidarity across national lines. People have to help others in the understanding it helps themselves.

Crucial decisions need to follow up on the first steps taken at the December EU summit when Chancellor Merkel and President Sarkozy advanced the long-term solution of a new constitution for Euro-countries at least to create a centralized fiscal and regulatory authority backed by the European Court of Justice for enforcement, all necessities for a common currency.

Today, as Philip Stephens writes in the *Financial Times*, "National politics trump European interests."

True, so the challenge is to bring the two into synch. National politicians of influence have to defend the EU with courage and determination.

There must be acceptance that those who cannot do so will be choosing to be on the outer circle of a new European Union of variable geometry, either because they cannot afford to stay in the euro or because their electorates genuinely believe their interests lie elsewhere.

Even from outside the core group on common currency issues, David Cameron needs to push back the Tory right wing and the tabloid press and reel Britain back into Europe's mainstream where Britain belongs, and where the British voice is needed to soften continental bureaucracy and historic aversion over transparency.

Britain and continental partners need each other. Any notion Britain has an alternative reference point for economic and foreign affairs is nostalgia-driven cognitive illusion.

Leaders should debunk the populists' bluster over identity issues. Is France any less French because of the EU? Multiple identities are thoroughly feasible with a change in political behaviour.

If leaders take the steps necessary, the EU will survive, but not as it was.

As Giuseppe di Lampedusa wrote about 19th century Sicily in *The Leopard,* published in the EU's formative year of 1958, "If we want things to stay the same, things will have to change."

The year 2012 will bring defining change to the European Union, no question. The directions of inevitable transformative change, positive or negative, will rely on human capacities for belief, trust and perspective.

If European leaders can find the courage to overcome secrecy, bureaucracy and bitter consequences of austerity, then the markets will follow.

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