The strategic weakening of debt-ridden Europe

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CHAPTER 2

The strategic weakening of debt-ridden Europe

Daniel Möckli

The debt crisis has strategic consequences for Europe. The EU's role as an anchor of stability among its member states has been weakened. Intra-European power shifts, political fragmentation, renationalisation dynamics, and declining public trust in the EU have thrown the European project into its biggest crisis ever. In foreign policy, the EU's clout is shrinking for lack of cohesion, money, and political will. European defence is bound to suffer from a credibility deficit unless decreasing military expenditure is compensated with more 'pooling and sharing'. While the EU is resilient enough to prevent collapse, it faces years of austerity in more than just economic terms.

German Chancellor Merkel and France's President Sarkozy after a joint briefing at the EU summit in Brussels, 23 October 2011

The debt crisis has hit Europe hard. Many countries have been forced to resort to austerity measures not seen in decades. Drastic spending cuts, tax increases, and structural adjustments have led to growing economic hardship, particularly in Southern and Eastern Europe. The EU-27 unemployment rate has risen to 10 per cent by early 2012. Almost a quarter of Europe's young people (below 25) are without a job. Social unrest has grown and may yet intensify should the situation in countries like Greece, Spain, Portugal, or Hungary deteriorate further. Across the continent, domestic politics have been shaken by the crisis, with several governments ending prematurely. While electorates are still voting responsible leaders into office in most places, trust in public institutions and democracy is eroding, and populism is on the rise.

The European Union has been badly bruised by the debt crisis too. Its single currency, long praised as the key symbol for Europe's unity and a major source of integration, has unleashed highly divisive dynamics. For several Eurozone member states, it has actually become a main cause of their economic weakness. EU crisis management has proven to be exceedingly slow and is subject to much controversy. While the process of European unification has seen many difficulties in past decades, the current crisis is more severe than any before. To be sure, talk of a collapse of either the euro or the EU seems premature. The European project is bound to last. The EU may even resurge in a more unified and more competitive shape one day. But there is little doubt that its troubles will not go away anytime soon. Europe faces a period of austerity in more than just economic terms.

These developments have strategic consequences. Some of them concern the outside world, as the state of the EU economy has a major bearing on the growth potential of many other countries, including China (see Chapter 1 in this publication). First and foremost, however, the debt crisis has major repercussions on Europe itself. Three such repercussions, which collectively amount to a strategic weakening of Europe, are the focus of this chapter.

First, as a result of Europe's economic and political malaise, the nature of the European project is changing. The current power shifts within Europe, the sidelining of EU institutions, the increasing fragmentation among member states, and the growing legitimacy deficits of the EU are all weakening the role of the EU as a major anchor of stability in Europe.

Second, Europe's long-term relative decline in the global context has been accelerated by the debt crisis. Its share of economic power is shrinking ever faster. Its global standing has taken a blow by the way in which it has handled the euro crisis, not least since it has become the object of IMF intervention and felt compelled to woo emerging powers for financial help. Much more significantly, the EU's capacity to implement a common foreign policy and defend collective European interests in an increasingly non-Western world has been further diminished. Its inability to come up with a strategic response to the monumental changes that have occurred in Southern Mediterranean countries since the beginning of 2011 speaks volumes in this regard. With its Common Foreign and Security Policy (CFSP) receiving less attention and fewer resources, and with cohesion and trust among member states decreasing, any positive post-Lisbon effect has largely been undone. Foreign policy is being renationalised in crisis-driven Europe, which bodes ill for the EU's ability to project stability to its neighbourhood and play a global role commensurate with its economic weight.

Third, the debt crisis has also left its mark on European defence. In many European countries, armed forces had been underfunded well before the recent fiscal straits set in. But the dramatic new cuts now being decided in numerous capitals, coupled with the lack of coordination in reducing national military capabilities, suggest that Europe may be reaching a tipping point as far as the credibility of its defence and military crisis management capacities are concerned. There are those who predict a gradual 'demilitarisation' of Europe. However, in the case of defence, it seems just conceivable that the debt crisis may actually have the positive effect of pushing states towards more 'pooling and sharing' or 'smart defence', eventually leading to a 'remilitarisation' of Europe.

This last point does suggest that the debt crisis will not necessarily only have bad outcomes for Europe. Less money will mean more incentives to set priorities. Less cohesion implies a new potential for multi-speed policy solutions that allow countries other than the EU-27 to secure a bigger stake in the European project. By shedding light on deficits and weak points, crises generally provide opportunities to adapt and put things on a firmer footing. On balance, however, the net strategic effect of the current economic and monetary turmoil for Europe is bound to be negative.

Sovereign debt as high politics

Just a few years ago, it seemed inconceivable that sovereign debt would become an issue of strategic relevance.

To most security analysts, terms such as 'bonds', 'bank capital ratios', and 'debt restructuring' were unfamiliar and appeared to belong to an economic world largely detached from the realm of high politics. But things have changed. In the wake of the global financial crisis, geo-economics came to the fore as a major feature affecting the worldwide redistribution of power (see Strategic Trends 2010). As the financial crisis in Europe spilled over into a debt crisis by 2010, issues relating to sovereign debt and EU monetary union began to have a strategic impact on European unification on a scale unmatched by any other development since the end of the Cold War.

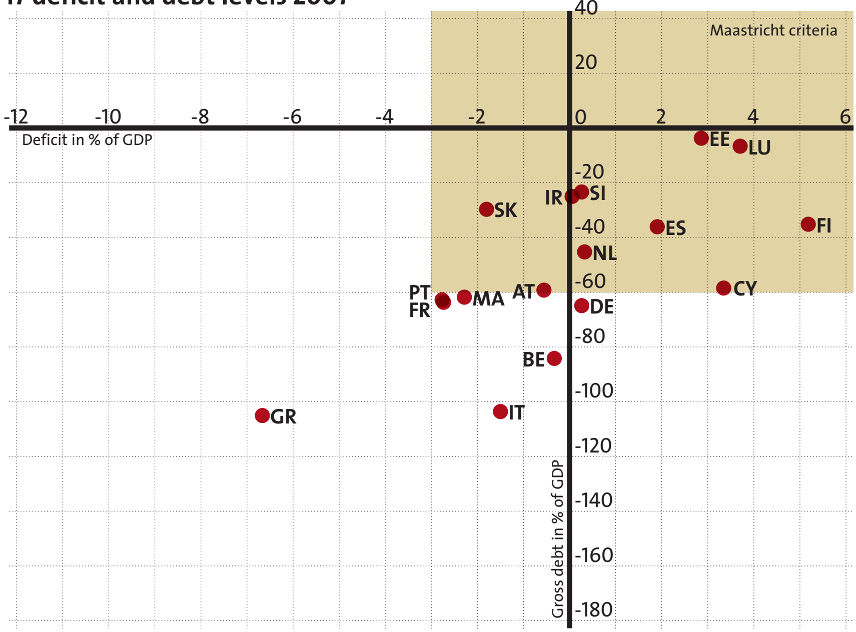
A complex crisis

The reasons why sovereign debt has thrown Europe into crisis are manifold. For one thing, the level of debt has risen dramatically in many European countries in the past few years. In some cases, this was the result of large bailout packages for the financial sector or stimulus measures designed to reverse the economic slowdown. In other cases, it was the cumulative result of long-term overspending. Whatever the specific reasons, the fact is that the ratio of government debt to GDP for the EU-27 has reached record heights of more than 80 per cent by 2012 and even exceeds 100 per cent in the cases of Greece, Italy, Portugal, and Ireland. Only five of the 17 member states of the Eurozone (EU-17), and only 13 of the 27 member states of the EU still meet the Maastricht convergence criteria of a debt level below 60 per cent of GDP.

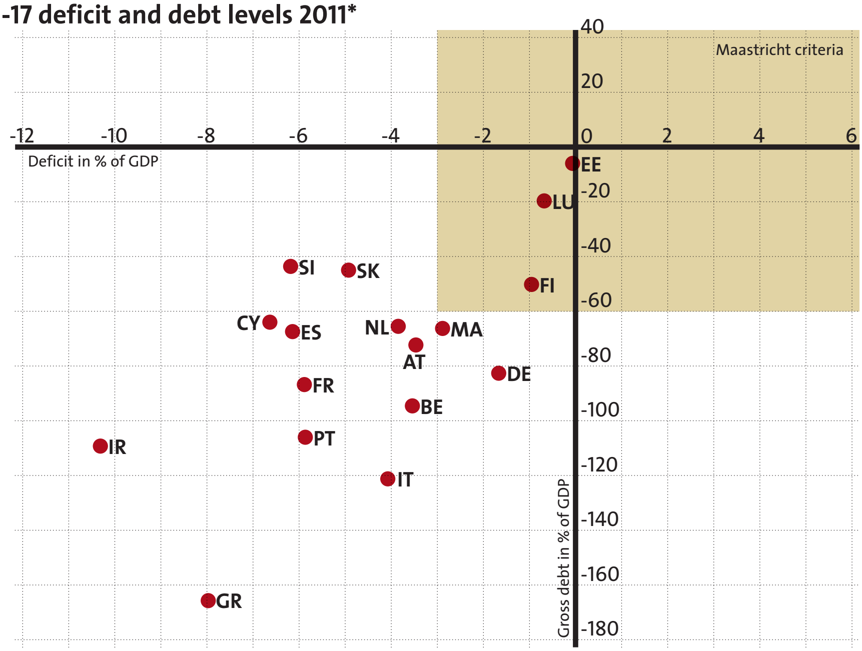
The crisis cannot, however, be explained with high debt levels alone. After all, Germany has a debt level of over 80 per cent but gets more favourable conditions at the bond markets than most other countries. Rather, it is market confidence that determines the cost of borrowing for each country. While a variety of factors account for why lenders and rating agencies have come to regard some countries as more creditworthy than others, membership in the European Monetary Union (EMU) has become a major handicap for a series of countries at Europe's periphery. These Eurozone members have experienced a loss of competitiveness as a result of the single currency, yet at the same time no longer have monetary instruments such as an adjustable exchange rate at their disposal to ease their economic and fiscal burden. Their weakness, in turn, has put a serious strain on the Eurozone at large, which is why the debt crisis is a euro crisis to a significant extent, too.

Part of the problem lies in the design of EMU. The single currency was

EU-17 deficit and debt levels 2007



EU-17 deficit and debt levels 2011*



Source: IMF, World Economic Outlook Database, September 2011

*Estimates

mainly launched for political reasons, despite the warnings of economists who cautioned that it might have counterproductive effects if imposed on such a heterogeneous group of countries with disparate fiscal and economic policies. Instead of becoming a source of economic convergence, the euro has in fact accentuated the differences in competitiveness during the first decade of its existence, as most members failed to keep up with Germany's rising productivity.

However, it was not so much the design flaw itself, but rather a series of actions taken by governments and markets that brought about the euro crisis. First, the Stability and Growth Pact that was created to compensate for the lack of fiscal union by enforcing budget discipline was hollowed out as early as 2005, when the EU, pressured by France and Germany, relaxed its rules. Second, because they benefited from low interest rates and easy credit conditions in the Eurozone, governments and households in Southern European countries significantly increased their borrowing in the past decade. Whereas Germany implemented far-reaching reforms of its labour market and pension system, these countries largely put off such structural measures. Third, when it became clear that Greece was no longer able to repay its debt in full, markets began to panic and introduced risk premiums to compensate for potential sovereign defaults, which for many countries led to growing yield spreads on government bonds relative to Germany. This caused new crises of illiquidity and insolvency for both states and banks, spreading the problem to major economies such as Italy and Spain. The inadequate capital levels of many European banks and the widespread linkages among banks and with sovereigns have done much to exacerbate the euro crisis.

The limits of EU crisis management

It is worth noting that the euro itself has not been fundamentally undermined by these developments so far. It has remained fairly stable against major other currencies, and it continues to attract large quantities of hard cash reserves. Nevertheless, the risks of default and contagion within the Eurozone have meant that it was the EU-17, and the EU at large, that have become both the epicentre of the European debt crisis and the primary platforms for crisis management efforts. The trouble is that neither the Eurozone nor the EU was built to manage such crises. Political decision-making is taking very long, with the number of emergency summits proliferating. Policy outcomes have often been ambiguous so as to get as many member states as possible on board.

Bold decisions have also been prevented by domestic constraints that have become manifest in both creditor and crisis countries. For all these reasons, the EU has found it very difficult to come up with solutions that are quick and solid enough to regain market confidence.

To be sure, some important measures have been taken. Euro governance structures are gradually being improved. A new intergovernmental fiscal treaty seeks to ensure fiscal discipline by obliging signatories to write debt brakes into binding national legislation and making excessive deficit procedures more automatic. Eurozone summits have been institutionalised to allow for more effective coordination of fiscal and economic policies. European rescue funds have been set up (and will become a permanent fiscal vehicle in the form of the European Stability Mechanism in July 2012) to provide financial assistance packages to countries in fiscal difficulties, tied to strict conditionality concerning austerity and structural adjustment. Beyond such governance measures, a writedown of privately-held bond debt was agreed in the particular case of Greece. It was also decided that banks in the Eurozone should increase their capital ratios. Moreover, outside the realm of EU politics, there was the bold decision by the European Central Bank (ECB) to offer unlimited three-year liquidity to squeezed banks. In terms of short-term crisis management, this turned out to be the most important measure of all, resulting in falling borrowing costs for crisis-hit countries and therefore buying valuable time for political leaders.

Nevertheless, market uncertainty has prevailed. For all the crisis management efforts, the majority of euro members were downgraded by rating agencies at the beginning of 2012, reflecting ongoing scepticism as to their ability fully to address the systemic stresses in the Eurozone. As the crisis is gradually shifting from acute to chronic, there continues to be much controversy as to the right remedies. There are those who propose measures such as an ECB 'bazooka' role of intervening as lender of last resort to Eurozone sovereigns, the introduction of Eurobonds to mutualise national debts, or an easing of austerity for the sake of growth-oriented policies. Others, particularly Germany, will have none of this, arguing that the only way for crisis countries to become more competitive is through budget cuts and supply-side reforms.

Muddling through as the likely way forward

How the euro crisis will be resolved is impossible to predict at this stage.

It may well be that market confidence can only be fully regained again if monetary union is complemented by fiscal and political union. Yet, such a major advance in European integration seems completely off the cards. In Germany and other solvent countries above all, domestic resistance would likely be insurmountable, as national sovereignty would become all but meaningless with such a move.

The opposite scenario of a demise of the Eurozone or even the EU appears equally unlikely. There is simply too much at stake politically and economically for European leaders to let this happen. While a default and return to a national currency remains a distinct possibility for Greece in particular, precautions are gradually being taken to contain the negative effects of such a development.

The most probable scenario, therefore, is for Europe to continue to muddle through. There will be more of the same in terms of austerity, adjustments, EU late-night summit meetings, and rescue packages. For crisis-hit countries at Europe's periphery, this will mean long periods of hardship, with ever growing social costs. But the Eurozone and the EU proper face difficult years ahead too, with the EU-17 having fallen into recession in 2012 and the EU-27 struggling to stick with just a little growth. The bottom line of all this is that the EU will likely remain bogged down in crisis management for years to come.

The EU as a weakened anchor of stability

Although it remains unclear where the EU will eventually be heading, some strategic repercussions of the debt crisis have become gradually manifest. If European unification has always been about both enhancing stability on the inside and defending common interests on the outside, both functions have been weakened by recent events. None of this is irreversible, and the picture becomes more nuanced on closer examination, but the overall trends are negative – and bound to stay so for a while.

Let us start with the decreasing capacity of the EU to serve as an anchor of stability among its member states. This is not to suggest that Franco-German reconciliation and the European security community, i.e., Europe's key post-war achievements that emerged on the twin basis of European integration and NATO collective defence, are about to unravel. There will be no return to conflict resolution by military means between EU countries, even if some military planners have paid more attention to such a scenario lately. Still, the nature of the European project is changing in ways that do have negative effects on the EU and its ability to function as a stability anchor. If the debt crisis itself has not caused most of these changes, it has been a decisive accelerator, reinforcing developments to an extent that renders them strategically relevant.

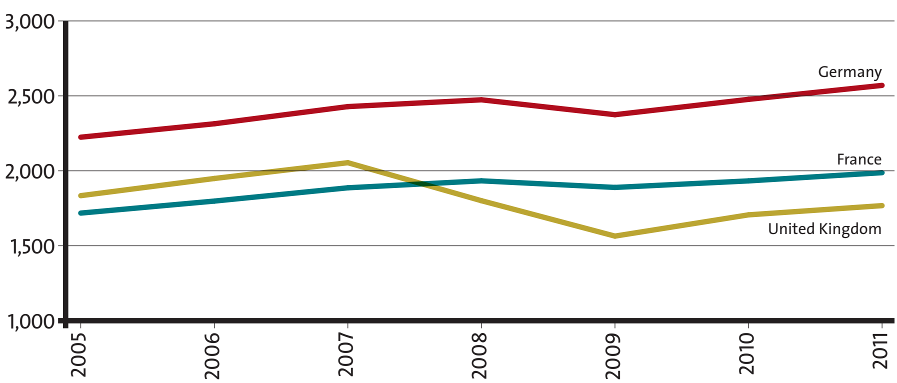
Power shifts and new uncertainties

Power shifts are generally accompanied by a growing degree of uncertainty, strain, and distrust. This holds true for the global level as much as for Europe. The most notable – and most sensitive – shift of power within Europe in the course of the debt crisis concerns the rise of Germany to the position of the EU's indisputable leader. Germany's economy has witnessed a boom when many other countries have suffered. Its unemployment rate has fallen to just above five per cent. Its role in managing the euro crisis has become so central that all eyes are set on decisions taken in Berlin. Never before in the history of European unification has there been a similar degree of preeminence of any single country.

Germany has not sought this leadership role. Nevertheless, as has been rightly suggested, there has been a return of the almost forgotten 'German question' as a result of the euro crisis, albeit in an economic variation. Europe's single currency was meant to resolve the century-old problem of Germany being too strong for a European balance of power but too weak for hegemony. As it turns out, the currency union has actually revived this question. Although Germany has made major financial commitments

Power shifts within Europe: Germany, France, United Kingdom

Absolute GDP in current prices in € bn



Source: Eurostat 2012

to crisis-hit countries, it has become the subject of much criticism. While there is some admiration for the German economic model, there is also a notable resurgence of the notion of the 'ugly German' who seeks to impose solutions and Germanise Europe.

The relative weakening of France and Britain vis-à-vis Germany implies that trilateral leadership, often an important prerequisite for effective EU action, will be more difficult to accomplish than ever. Furthermore, while there is still a degree of Franco-German bilateral leadership, the notion of 'Merkozy' can only thinly disguise the fact that Paris has been downgraded to junior status in relations with Berlin. But beyond changing dynamics in European great power relations, there is also a widening north-south divide in Europe that may diminish the willingness to cooperate and the ability to identify common ground. Still another fragile balance currently being undermined concerns relations between small and big states in the EU, as the former have been largely sidelined in the search for a way out of the euro crisis.

Finally, power is also shifting from EU institutions back to member states. The long-term trend of incrementally strengthening the European Commission and the European Parliament has been reversed. Jean Monnet's vision of supranationalism is on the wane, while the Gaullist concept of an intergovernmental Europe takes centre stage. Increasingly, European politics are being renationalised, with the Union method gaining ground at the expense of the Community method. Perhaps such a development was unavoidable, given what is at stake in Europe these days. But the fact that national governments are taking matters more into their own hands again suggests that defining common interests and policies will become ever more complex in the EU. It also enhances the risk of yet another shift, from a rule-based to a power-based Europe.

Fragmentation

In parallel to the 'German question', a second major issue of European geopolitics has resurfaced in the context of the debt crisis. The 'British question', i.e., the issue of Britain's relationship with Europe, was a major bone of contention during the first two decades of European unification. While it seemed settled when London joined the EC in 1973, it has in fact continued to simmer, as most British governments have pursued a policy of semi-detachment vis-à-vis Europe. The matter has now seen a full-blown comeback, with Britain's decision not to sign the fiscal treaty raising questions as to London's future role in the EU.

Although Britain had already opted out from EMU, it still signed the Maastricht Treaty. Its absence from the fiscal treaty takes British self-marginalisation in Europe one step further and may well result in London being excluded from major decisions on future economic and fiscal policy. Such an empty-chair approach could easily backfire, given that austerity-shaken, post-industrial Britain has become highly dependent on the City's financial services as the backbone of its economy. Having said that, it may actually only be the beginning of a process leading to Britain's further withdrawal and eventual exit from the EU. Recent polls suggest that Euroscepticism is reaching new heights in Britain. What is more, the present British government shows no interest in shaping politics in Europe anymore, or, for that matter, in balancing Germany.

It is ironic that Britain is moving to the sidelines in Europe just when the EU evolves in ways long advocated by London. The fact is that a Europe without Britain will leave London isolated and the EU weak, particularly on the international stage. But the resurgence of the 'British question' is only part of a bigger process of fragmentation in the EU. For one thing, the Czech Republic has not subscribed to the fiscal treaty either, and other countries might follow suit should domestic ratification fail. An even more serious development is the widening gap between the EU-17 and the other ten members of the EU as a result of the euro crisis.

To be sure, two-speed or multi-speed solutions of European unification are not necessarily bad. They may be the best means available to ensure effectiveness despite diversity. Even models of variable geometry or concentric circles, assuming a long-term gap in integration levels, may allow EU cohesion to be preserved if managed carefully. However, there is a real danger that Europe's growing fragmentation will gradually result in two or more distinct European entities that have different priorities, interests, and perhaps even identities, though still under the common EU roof. Even more than Britain's potential detachment, such a rift is bound to weaken Europe's internal stability as well as its influence in the world.

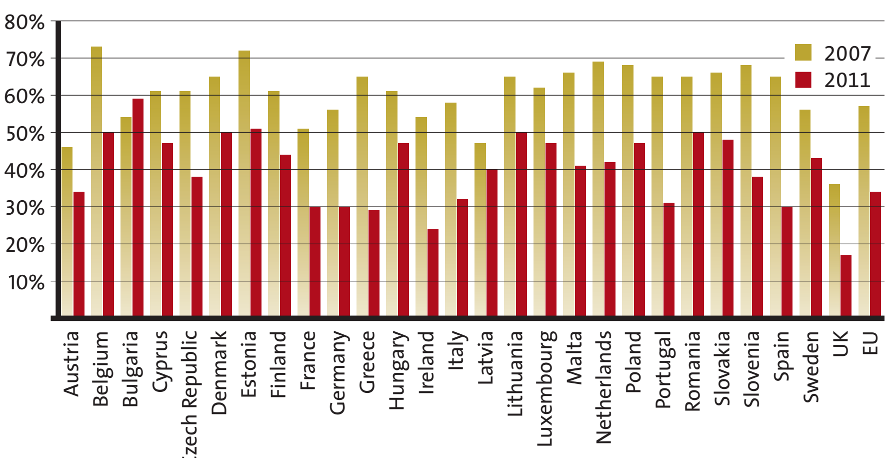
Growing legitimacy deficits

Apart from changing power distributions and centrifugal politics, there is a series of legitimacy deficits that, exacerbated by the debt crisis, pose a growing challenge to the European project. First, for all its new powers, the European Parliament, a major source of EU legitimacy, has been completely sidelined during the euro crisis. Even Jean-Claude Piris, a main architect of the Lisbon Treaty, has since called it a 'relative failure'. Second, the strict conditionalities attached to bail-out packages have resulted in an erosion of sovereignty and domestic accountability of crisis-hit countries, weakening the democracy credentials of the EU further.

Third, declining public support for European unification has become a major challenge for EU legitimacy. Although the single currency itself remains fairly popular, according to Eurobarometer, the number of respondents who have trust in the EU is rapidly eroding, having fallen from 57 per cent in 2007 to 34 per cent in 2011. The EU's image has taken a severe blow too, with less than a third now perceiving it in positive terms. In Southern Europe, the EU is increasingly seen as an 'austerity union' bringing hardship rather than prosperity. In the North, people complain it has become a 'transfer union'. But the problem goes beyond this. With unemployment rising, some of the EU's major projects of past decades are being questioned, such as Eastern enlargement, Schengen border policies, and the free movement of workers. Depicting the EU as a scapegoat for many misfortunes, populist parties across Europe are now embracing Euroscepticism to attract new voters beyond the anti-immigration and anti-elite crowds.

EU: Eroding public trust

Percentage of respondents who tend to trust the European Union



Source: Eurobarometer 2012

There is no doubt that ensuring domestic approval for EU matters by either parliaments or electorates will be a major challenge for national leaders in the years ahead. This leaves them with two unpalatable options: They can either circumvent the national level as much as possible, with the EU's legitimacy deficits growing further. Or they can seek domestic approval for their EU policies, which renders the EU politically vulnerable and may result in further fragmentation.

EU foreign policy: Lisbon undone

The debt crisis and the EU's internal weakening have major repercussions for Europe's relations with the outside world too. For one thing, these developments will accelerate Europe's long-term relative decline in terms of economic power. On average, emerging and developing economies have done much better than Europe in terms of GDP growth in the recent years of crisis. They are expected to continue to grow by more than five per cent in the coming two years. However, from a European perspective, it is not so much the further loss of economic power that is worrying as the damage recent events have done to Europe's efforts to manage this decline and preserve its global influence.

The notion of a European foreign policy has been significantly bruised by the debt crisis. This has traditionally been one of the most challenging dimensions of European unification anyway. After decades of very limited achievements in this area, the Lisbon Treaty had raised hopes that the Europeans would finally be able to act more coherently and strategically in the international arena. The new European External Action Service (EEAS) and the enhanced status and role of the High Representative were just two of several Lisbon innovations designed to give Europe's foreign policy a major boost. Yet, a positive Lisbon effect has never really materialised. As the debt crisis has made painfully clear, institutional innovations alone are not sufficient for Europe effectively to speak with one voice and safeguard common interests if the overall setting is not right.

To be sure, not all aspects of European foreign policy have been equally hit by the debt crisis. Sanctions policy, for instance, seems largely unaffected by recent events, as the EU has managed to agree on tough measures against countries such as Iran and Syria. Climate and trade policies are other examples where continuity and cohesion seem to prevail. Furthermore, there are cases where the crisis may yet have positive side-effects. For instance, austerity prerogatives may well mean less EU development spending, but they will also be a catalyst for a more focused and differentiated EU approach in this policy field. Given that the EU currently provides aid to more than 140 countries, implementing Commission proposals to cut off payments to emerging powers such as China, India, or Brazil seems long overdue.

Overall, however, the debt crisis has taken a significant toll on 'Global Europe'. Even though talk of EU strategic retrenchment or Euro-neutralism seems off the mark, the state of European foreign policy is not good. As the conditions for effectively speaking with one voice deteriorate, the characteristics of European foreign policy are changing, with renationalisation becoming a prominent feature here too. As a consequence, negative trends that had affected Europe's role in its neighbourhood prior to the crisis are being reinforced, and the EU's global credibility is taking a further blow.

Worsening conditions, changing characteristics

If European foreign policy-making has always been a delicate affair, its conditions have worsened in three ways as a result of the debt crisis. First, CFSP and other aspects of EU external relations have received far less political attention recently, as leaders were absorbed by quasi-permanent economic crisis management. This has proven a major handicap, as foreign policy issues often cannot be settled on the bureaucratic level alone. Second, even if it should attract more political attention again, European foreign policy will suffer from a shortage of money for years to come. With national budgets strained, this is not the time for major foreign policy spending. This is also why recent Commission proposals for a bigger EU budget, a relative increase of external action expenditure (from 5.7 to 6.8 per cent of the overall budget), and more budget autonomy for the years 2014 to 2020 look highly optimistic, to say the least. Third, the tensions and recriminations the euro crisis brought to member states will have a detrimental effect on foreign policy too. In a predominantly intergovernmental setting such as CFSP, effective joint action depends not just on common interests but also on mutual trust – which has been markedly waning lately.

Given this difficult context, it comes as little surprise that European foreign policy is being renationalised to a significant extent. Contrary to Lisbon intentions, recent dynamics have further strengthened national capitals rather than Brussels institutions when it comes to foreign policy-making. The EEAS, with more than 1,500 staff in Brussels and more than

2,000 in EU embassies, has not been able to make a major difference so far. It has failed to win the confidence of member states, 12 of which have even criticised it collectively for bureaucratic inertia and mismanagement. With EU institutions weak and intergovernmental coordination difficult, some member states are now simply turning their back on CFSP. Britain is an obvious example.

Related to the point of renationalisation, there is a widening gap between national and EU foreign policy as far as substance is concerned. In response to both the growing importance of geo-economic power in the new polycentric world and their own economic difficulties, more and more member states are moving commercial diplomacy to the centre of their foreign policy. Bilateral investment deals and economic cooperation agreements with emerging powers are what they are particularly after. The EU, by contrast, finds it difficult to adapt to such a geo-economic world. Although itself a powerful economic actor in many ways, its foreign policy continues to have a strong leaning towards the promotion of norms like democracy, the rule of law, and human rights. Such disparate priorities between Brussels and some national capitals render the definition of a cohesive European foreign policy exceedingly difficult.

The characteristics of European foreign policy are also changing in that the EU's soft power has been eroding as a result of its economic problems and political strains. Its model of governance has obviously lost some appeal for others. Similarly, EU calls for effective multilateralism do not sound very credible on the international stage these days. To be sure, the EU is still a very attractive market. Also, the political pluralism and the values of liberal democracy it represents are achievements that protesters are eagerly fighting for in many parts of the world these days. Still, Europe's power of persuasion has waned – which is a particular handicap as far as its ability to influence developments in its neighbourhood is concerned.

Neighbourhood: Negative trends reinforced

The EU's appeal to neighbouring countries has been a major basis from which to shape its regional environment in the past two decades. This has worked best in the form of enlargement, with candidate countries willing to meet economic and political conditionalities to get the benefits of EU membership. It has generally proven less effective with those many neighbours that lack a membership perspective and are instead promised a 'stake in the internal market' in exchange for domestic reform. As both these policies – enlargement and the European Neighbourhood Policy (ENP) – have been negatively affected by Europe's current crisis, the EU approach of projecting stability by fostering regional transformation will be very difficult to implement in coming years.

EU enlargement, long the most effective foreign policy tool of the EU, had lost steam prior to the debt crisis already. Enlargement fatigue in Europe became manifest after the EU expansion to the East. But it has significantly deepened lately as public perceptions of the EU have become more critical and unemployment figures are rising. What is more, some of the countries with candidate or potential candidate status seem to have second thoughts about the desirability of EU membership themselves. Above all, this holds true for Turkey, which has positioned itself as a regional power of its own and looks more to the US than to crisis-ridden Europe these days when alignment with the West seems expedient. However, there is also less appetite for EU accession in the Western Balkans, where EU euphoria is gradually being replaced by disillusionment, especially in Bosnia and Herzegovina, Macedonia, Albania, and Kosovo.

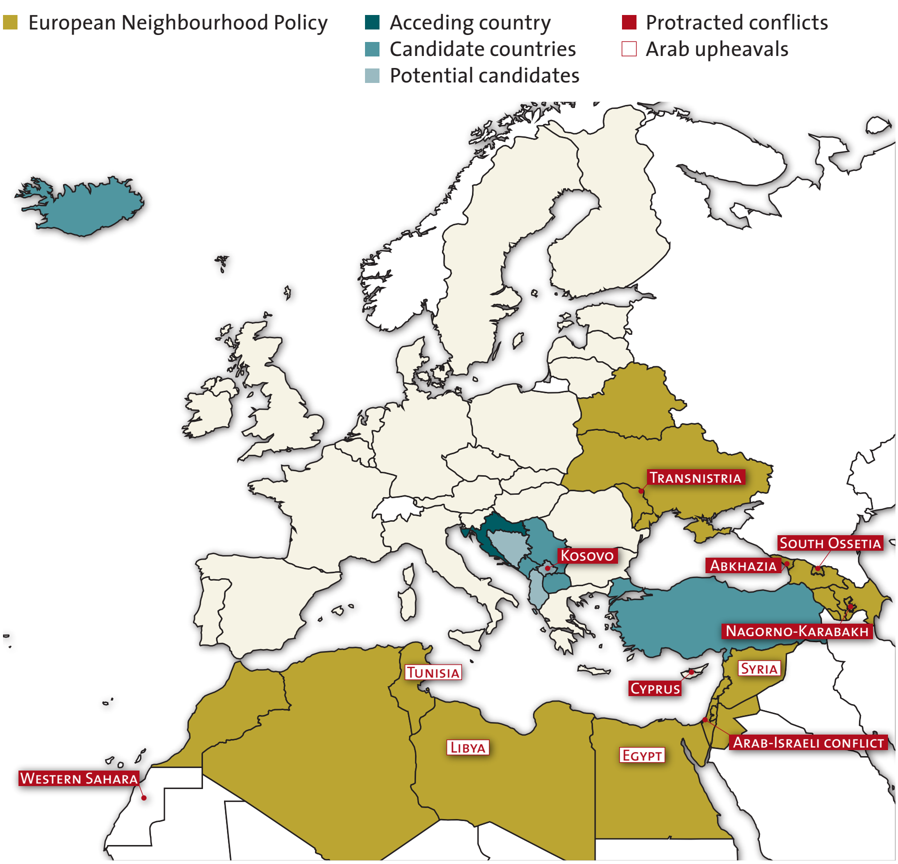
Where this leaves enlargement after Croatia's accession to the EU in 2013 is unclear. Any further widening of the EU is bound to be a long way off. The EU's influence over (potential) candidate countries is likely to shrink as long as uncertainty about enlargement prevails. There may yet be new dynamics of enlargement should any multi-speed framework of Europe materialise. But it remains uncertain whether such a framework could provide what new members want from the EU – and whether it would actually enhance stability in Europe.

As for ENP, its 'enlargement-lite' approach has failed to have a meaningful impact on Europe's southern and eastern neighbourhood from the start, as have complementary multilateral schemes such as the Mediterranean Union or the Eastern Partnership. The Arab awakening has been a painful reminder of how marginal the EU's role in many neighbouring countries still is. The revolts and revolutions that have shaken the MENA region mark the strategically most relevant development in Europe's neighbourhood since the demise of the Soviet Union (see Strategic Trends 2011). Yet, sanctions aside, these events have unfolded with the EU largely as a bystander. Forging an answer commensurate with the size of the challenge would have been a daunting task for the EU even at the best of times. Doing so at a time of its own weakness is simply beyond its reach.

Admittedly, the EU has refined the ENP as a result of the Arab awakening. Under the slogan 'more for more', it now offers enhanced incentives in terms of 'money, markets, and mobility', coupled with greater differentiation depending on how willing respective ENP members are to reform. However, the trouble is that the EU will hardly be able to deliver these incentives. In austerity-shaken Europe, there is no political will to either finance large-scale transformation packages or open up European borders for agricultural products or workers from ENP countries.

Moreover, even if the EU were in a position to give MENA countries what they wanted, the latter might still turn down European assistance if tied to too many conditions. As long as the EU is mainly trying to extend its own rules to these countries and

Europe and its neighbourhood



draw them into a sense of regionalism marked by EU values, it will find it difficult to develop proper partnerships with them. In a neighbourhood marked by increasing competition between 'new' and 'old' external actors, a more strategic EU approach than ENP would be necessary for Europe to safeguard its interests. Yet, in its present state, the EU will find it very difficult to come up with anything new and bold for the MENA region.

Less Europe in the world, more China at home

Strategy may be a weak point in EU dealings with the neighbourhood. But it has traditionally been even more absent on the global level. Although the EU has set up a system of 'strategic partnerships' with BRIC and other countries such as the US, Canada, Japan, South Korea, Mexico, and South Africa, these partnerships lack both substance and focus. If the EU has shown its ability to make a difference collectively in global governance frameworks like the UN, it has performed poorly in the key business of defining common priorities in its relations with the major powers. Its global footprint has remained limited, therefore, despite ambitions to the contrary.

The current crisis in Europe may further expose the EU's weakness as a global power. But here, the net effect will be more limited than on the regional level, as there has never been much of a policy in the first place. Member states will place increasing emphasis on bilateral relations and their own 'strategic partnerships' with emerging powers, which in turn will play them off against each other and have no reason to perceive the EU as a credible unit. Berlin, Paris, and London are what matters from outside Europe, with the first joint Sino-German cabinet meeting of summer 2011 pointing to things to come.

The one thing that does seem to change in Europe's relations with the world as a result of the debt crisis is that the latter is increasingly called to rescue the old continent. The IMF providing financial support to Greece, Ireland, and Portugal is one thing. But there is also the phenomenon of China rapidly expanding its economic presence in Europe. While Beijing has remained reluctant to purchase massive amounts of bonds from crisis-hit EU countries or contribute substantially to the European rescue fund, it has been very active in buying European companies and investing in strategic assets such as ports. Albeit from a low level, Chinese foreign direct investment in Europe is currently skyrocketing, amounting to a third of total Chinese FDI in 2011. Much more is expected to flow in coming years, as

Beijing has announced a major expansion of its FDI activities. With crisis-hit countries in Europe's south showing particular eagerness to get Chinese investment, there are concerns that China will win political leverage over them and might affect their voting behaviour when it comes to the EU's China policy. Chinese leaders themselves have made it clear that they are ready to help the Europeans deal with their crisis – provided the EU stops criticising China on issues such as currency policy.

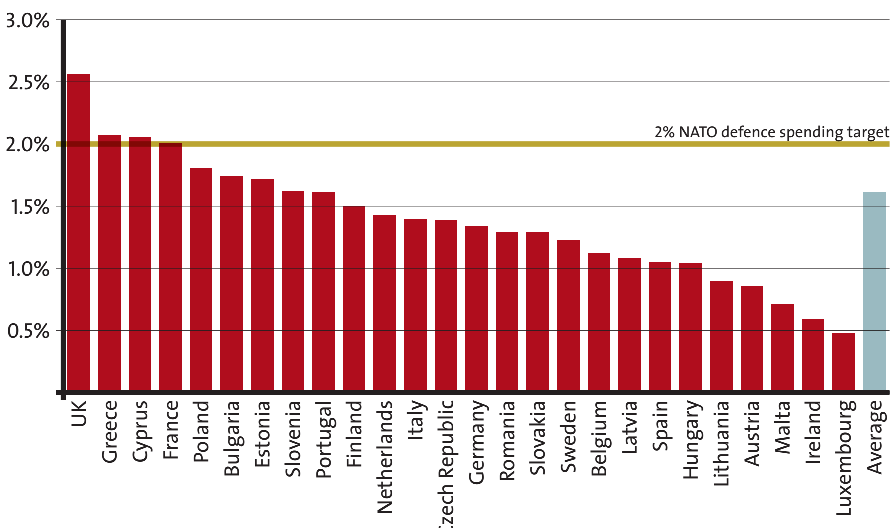
European defence: From cutting to sharing?

If foreign policy had been a sore spot of the EU even before the debt crisis broke out, the same can be said for European defence. Many armed forces in Europe have been underfunded for years, reflecting both the absence of a clear enemy and domestic reservations about the utility of force. Combined European defence spending has shrunk despite the Afghanistan war in the past decade, with almost all countries remaining well below NATO's agreed line of two per cent of GDP. Although most armed forces have been transformed to focus on crisis management rather than territorial defence, there has been a conspicuous shortage of relevant military capabilities.

The EU's Common Security and Defence Policy (CSDP) experienced some dynamic first years, marked by the

EU-26 defence expenditure 2010

Percentage of GDP



Source: EDA 2011

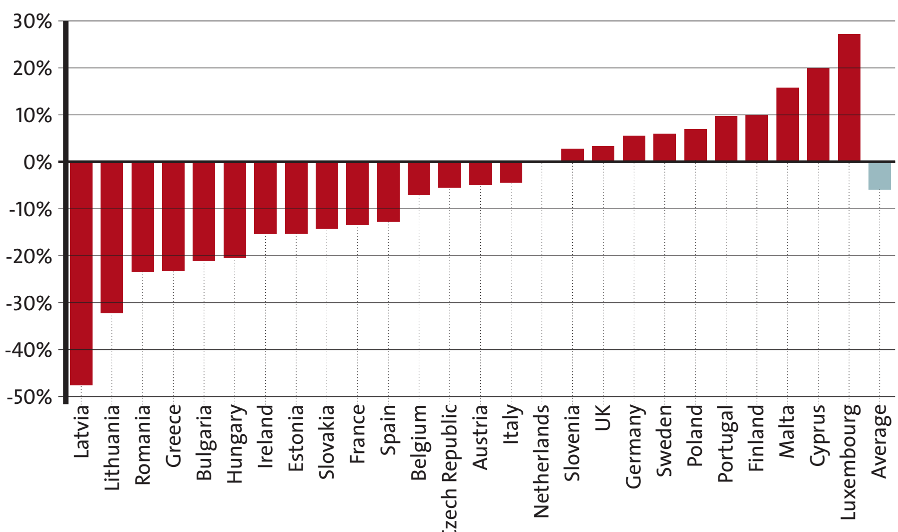
setting up of institutions, the forging of a security strategy, and the launch of about two dozen crisis management operations (many small and civilian in nature). But it has gradually run out of steam. Intervention fatigue has crept in, with only one new operation launched since 2009 and EU battlegroups remaining unused. The lack of strategic consensus, as reflected in the split over Libya between Germany on the one side and Britain and France on the other, has become a major liability. There is also no agreement on EU-NATO relations and the role and purpose of CSDP, with Britain vetoing an EU Operational Headquarters. As CSDP achieved rather little despite much effort in its first decade, renationalisation tendencies set in years ago.

The debt crisis may well lead to a further demilitarisation of Europe, as several analysts predict. However, contrary to the case of European foreign policy, there is a more positive scenario here too, in that the debt crisis may actually become a catalyst for more defence cooperation.

The spectre of demilitarisation

There is no doubt that the current period of austerity will result in a further decrease of Europe's overall defence spending. Already during the early stages of the crisis between 2008 and 2010, the EU-26 (Denmark has opted out from CSDP) have reduced their aggregate defence expenditure by 4 per cent. Further massive cuts have since been announced in many capitals.

EU-26: Percentage change in defence expenditure 2008–10



Source: EDA 2011

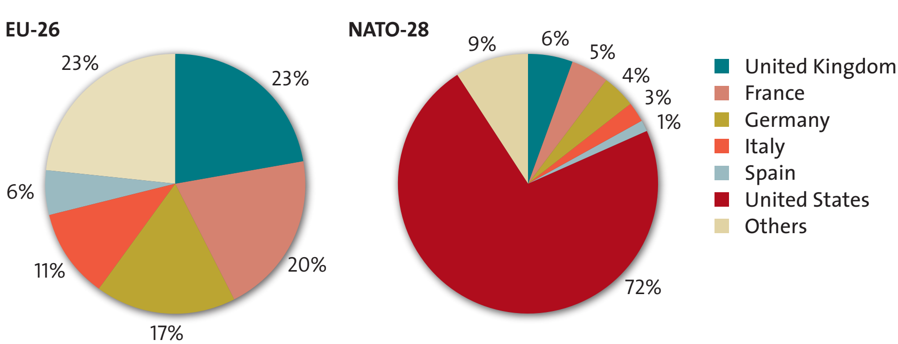
The combined effect of all these cuts could be severe. The shortages of personnel and capabilities in on-going missions are growing already. Further capability shortfalls will be unavoidable if states continue to reduce their national assets in an uncoordinated manner. Adjustments in the national level of ambition and the deployable capability of armed forces are bound to follow. What is more, as ever more modernisation projects are being delayed or called off, the European defence industry is increasingly compelled to turn to customers outside Europe, wooing them with technology transfers of unprecedented scale.

Under such conditions, the numerous obituaries for CSDP that are currently being drafted may well be justified. Even NATO, a much more established and institutionalised defence cooperation format than CSDP, faces an uncertain future. As the outgoing US Secretary of Defence Robert Gates put it during his last visit to Brussels in 2011, NATO has turned into a two-tiered alliance where the US covers three quarters of combined defence spending, while many European allies no longer have the will or means to share the burden. Gates predicted that the US body politic will hardly put up with this state of affairs much longer, warning of the 'very real possibility of collective military irrelevance' unless current negative trends are being reversed.

Hopes for remilitarisation

European defence may indeed be heading for a major crunch. However, there are two factors that offer grounds for cautious optimism that we may gradually see a turn to more

National shares of EU-26 and NATO-28 defence expenditure 2010



Sources: EDA 2012, NATO 2011

rationalised defence spending and more defence cooperation in the years to come. First, the coming budget pressures might be of a scale that leaves national capitals little choice but to seek cooperation to avoid a major credibility crisis. If armed forces have so far managed to muddle through despite insufficient resources, the consequences of further cuts might be much more severe. Second, changes in US defence strategy are bound to reinforce the view that the Europeans will have to do more for their security in the future, which potentially will serve as a driver of European cooperation. US defence cuts, while massive in absolute terms, are not the main trigger here, amounting to a mere eight per cent over the next decade. The real game changer, instead, is the shifting focus in US strategy from the Atlantic to the Pacific, which suggests that a strategically more autonomous Europe can no longer count on Washington to ensure stability in its neighbourhood. Libya may be a harbinger of things to come in this regard.

With concerns about the security of Europe mounting, there has been renewed interest in the old idea of 'pooling and sharing' lately. On the EU level, defence ministries have come up with an inventory of potential synergies concerning the procurement and operational use of military capabilities in the framework of the so-called Ghent Initiative. In November 2011, they agreed on a shortlist of 11 projects, committing themselves to tackling some of the key capability deficits the Libyan intervention had so painfully confirmed, including strategic enablers such as surveillance and air-to-air refuelling. Under the catchword of 'smart defence', NATO too is looking into 'pooling and sharing' again, declaring it a major topic for the Chicago summit in May 2012.

European defence: More cuts ahead (examples)

Country	Announced cuts
Austria	7.7% from 2011 to 2014
France	3.7% from the defence budget 2011–13
Germany	3.5% from 2011 to 2015
Greece	22.3% from 2011 to 2015
Ireland	15% from 2011 to 2014
Portugal	11% in 2011, additional 3.9% in 2012
United Kingdom	8% from 2011 to 2014, more cuts under discussion

Various sources

As European defence expenditure is unlikely to rise anytime soon, attempts to do more with less in the sense of jointly reducing capability shortfalls and unnecessary duplications make perfect sense. The problem is that the old obstacles that prevented 'pooling and sharing' ideas from being implemented in the past are still there. Getting serious about 'pooling and sharing' may mean less national autonomy, less money for national projects, more paperwork, and more competition for national defence industries. For all these reasons, bureaucratic resistance is certain to remain strong.

This in turn suggests that 'pooling and sharing' will only become a hallmark of European defence if there is firm political will – and mutual trust. With leaders busy to save EMU, the EU/CSDP level may include too many countries to allow for such conditions at this stage. Accordingly, proceeding with bottom-up initiatives of smaller groupings may be the only way forward for now. The Franco-British treaty on defence of 2010 has been criticised for undermining CSDP. Yet, if Europe's two leading military powers actually manage to see through all the ambitious 'pooling and sharing' initiatives outlined in the treaty, European defence can only win. The same holds true for other cooperation projects below the EU level, such as the Visegrad format (Poland, Czech Republic, Slovakia, Hungary) or Nordic Defence Cooperation. In the case of defence, fragmentation does not necessarily imply a major rift and step back in European unification, as this has never been a very Europeanised policy field. Rather, it should be seen as Europe's best second chance eventually to build up a common defence policy in the first place – and put CSDP on a more solid basis.

Eurosclerosis 2.0

There is no question that the debt crisis does pose a very real and severe challenge to European defence, just as it weakens European foreign policy and the European project at large. Its impact will be felt for years. But the bottom line is that even if the picture is not good, there is no need to paint it too bleak either. The EU has encountered many crises in past decades, and it has revealed a remarkable resilience and adaptability to overcome them.

Incidentally, the biggest previous crisis in the history of European unification bore some striking similarities to the situation in Europe today. Referred to as 'Eurosclerosis', the period from 1974 to 1983 saw EC member states struggling with decreasing growth, growing unemployment, and currency turbulences. Relative power gains by (West) Germany, Britain's 'I want my money back' policy blockades, and diverging preferences for how to manage Europe's economic crisis after the post-war boom created an atmosphere of distrust that spurred renationalisation tendencies. Two ambitious projects of the early 1970s, i.e., the establishment of a European Union and EMU by 1980, proved impossible to implement. The third project of launching foreign-policy cooperation did get underway, but it quickly turned into a bureaucratic exercise producing few results. There was a deep sense of gloom about the European project during these years. Only with hindsight did it become clear that many parts of the complex mechanics of integration continued to function properly below the political surface, providing the basis for a dynamic *relance européenne* in the mid-1980s.

It may just be that we are in the midst of a similar period of Eurosclerosis today. Although the scale of the current crisis is obviously bigger, and the Cold War framework that used to keep the EC member states together is long gone, the EU is bound to persist. Internal crisis management may dominate EU affairs for years to come. Grand achievements in either foreign policy or defence are unlikely to appear. But there will be another shift from survival mode to an EU relaunch one day. When this will happen is impossible to predict. Leaving the current crisis behind will require much political leadership to rebuild trust, both among member states and between the public and the EU.