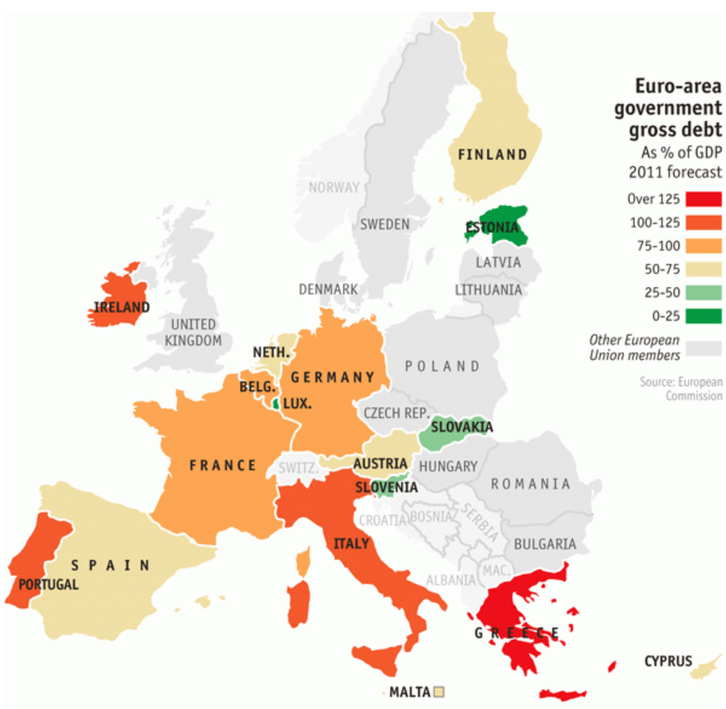
Staring Into the Abyss

The Economist
November 12, 2011

WHEN BRITAIN ABANDONED the gold standard in 1931, it was not only forsaking a system for managing the currency but also acknowledging that it could no longer bear the mantle of empire. When America broke the dollar's peg with gold in 1971, it ushered in a decline that continued until Paul Volcker re-established confidence in the currency in the early 1980s. As Joseph Schumpeter, the great Austrian economist, once wrote: "The monetary system of a people reflects everything that the nation wants, does, suffers, is." In the same way, the crisis that has engulfed the European Union (EU) is about much more than the euro. As government bonds, share prices and banks swoon and global recession knocks on the door, the first fear is of financial and economic collapse. But to understand what is happening to the currency you also need to look at what is happening to Europe.

The euro will not be safe until Europe answers some fundamental questions that it has run away from for many years. At their root is how its nations should respond to a world that is rapidly changing around them. What will it do as globalisation strips the West of the monopoly over the technologies that have made it rich, and an ageing Europe starts to look increasingly like the western peninsula of a resurgent Asia?

Some Europeans would like to put up carefully designed fences around the EU's still vast and wealthy market. Others, including a growing number of populist politicians, want to turn their nations inward and shut out not just the world but also the elites' project of European integration. And a few—from among those same elites, mostly—argue that the only means of paying for Europe's distinctive way of life is not to evade globalisation but to embrace it wholeheartedly.



This is not some abstract philosophical choice. It is a fierce struggle for Europe's future, being waged in Athens as George Papandreou loses power to a temporary government of national unity, in derelict factories in France and Belgium and in the wasted lives of millions of unemployed young Spaniards. This struggle will set the limits on Europe's welfare state. It will determine how the unbalanced partnership between Germany and France, and an increasingly detached Britain, will shape the EU. It will define the high politics of Brussels and the low politics of European populism. And it will decide the fate of the device that Schumpeter would see as the embodiment of all this: the euro.

Just now the euro zone is caught in a dismal downward spiral. Fears about whether the governments in Greece, Portugal, Ireland, Spain and, most alarmingly, Italy will honour their €3 trillion ($4.2 trillion) or so of borrowing are wrecking European banks, which own their debt. Struggling banks undermine confidence and credit. Coming on top of fiscal austerity, this is bringing on recession, deepening fears that governments will be unable to pay back their debts, which further weakens the banks. And so the vice turns, down towards disaster.

The euro zone still has the capacity to stop this run on its banks and governments. As a block, it is less indebted than America and its public-sector deficit is lower. It has the money to fortify its banks against the default of Greece—and Portugal and Ireland, if need be. And it is minded by the European Central Bank (ECB), which can in principle stand behind those vulnerable governments by buying their debt in unlimited quantities on the secondary market. But the EU has repeatedly failed to put forward a convincing euro rescue. Its latest and bravest attempt, at the end of last month, fell short of the mark—just like all the others. That is because the Europeans are deeply at odds over what the crisis is really about, and riven by disagreement over what each country must contribute towards solving it. So long as the euro zone's members cannot settle these arguments, or at least agree that their differences matter less than finding a solution, the collective action needed to defend the euro will remain impossible.

Many roads to disaster

While the world waits for Europe to make up its mind, catastrophe is in the air. It could take many forms. A country might storm out of the euro—which the treaty forbids, but who could stop a determined government? European banks might suffer a fatal loss of confidence. Italy or Spain might become unable to borrow on decent terms. Or a government trying to impose austerity might be replaced by one that rejects it. Any of these could cause contagion and plunge the world economy into depression.

Some people speculate that Germany might lead a breakaway core of euro-zone countries. But as the Teutonic euro soared in value, banks and companies would lose huge sums on their assets abroad and its exporters would find themselves at a disadvantage. Besides, for Germany to flout an EU treaty so brazenly would damage all EU law, which argues strongly against it.

Greece is more likely to buckle under austerity and quit after a succession of governments like the new one. But it would be a desperate act. Banks would collapse and capital flee, and many of Greece's companies, unable to pay their euro-denominated bills, would go bankrupt. Already shut out of debt markets, Greece would probably lose all financial aid from the EU.

Amid recession and the contagion of a debt default, bank collapse or Greek departure from the euro, Europe's single market would be in danger. At an EU summit in 2008, when the financial crisis was raging, Nicolas Sarkozy chastised the commission for being too zealous in upholding competition. A senior official reckons that, if the French president had at that moment asked for a vote, the heads of government would have suspended the rules. The crisis today is at least as grave as it was then.

Since it is possible to avoid such a catastrophe, you might think that the worst will not happen. And indeed it is unlikely—but not impossible. Precisely because of the dire consequences, everyone is counting on the next person to see reason. The new Greek government might reckon that Europe would never let Greece collapse. At the same time the ECB and Germany might refuse to step in, because they do not want countries to evade reform. Or perhaps austerity might eventually lead to populists that turn away from the euro—to hell with the consequences.

A euro-zone central banker confesses that he has lately been thinking about historical catastrophes such as the first world war and wondering how the world blundered into them. "From the middle of a crisis", he says ominously, "you can see how easy it is to make mistakes."

Economic and Monetary Union (EMU) was supposed to banish the competitive devaluations that threatened the single market in the early 1990s. It promised to bind a unified Germany into the EU and pave the way for some sort of political union in Europe. Today that dream has not vanished altogether, but the single market is under threat once more. Europe's nations are at loggerheads, Germany is in a state of outrage, and the link between the euro and the nation state is more fraught than ever. EMU truly is, writes David Marsh, author of a history of the euro, "Europe's Melancholy Union".

"The 2008 crisis shows that the dominant economies were not as dominant as they thought," says Dominique Strauss-Kahn, the French former head of the IMF. "If Europe fails, it will suffer from low growth, economic domination and cultural domination." Can Europe turn back from the abyss? Only if the core countries will support the rest as they submit themselves to radical political, social and economic reform. Nobody should be under any illusions about how difficult that will be.

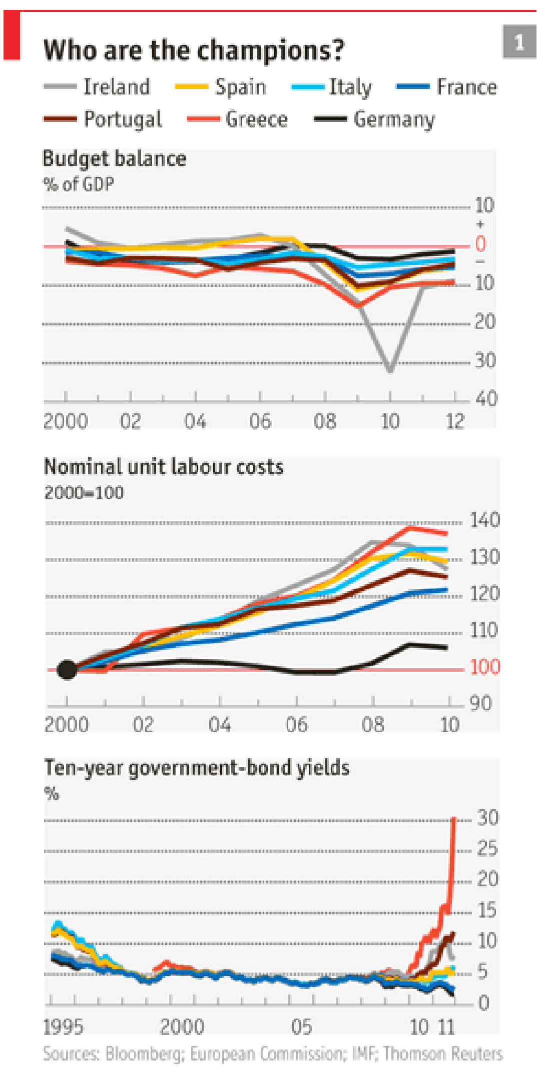
A Very Short History of the Crisis

IN GERMAN EYES this crisis is all about profligacy. Greece set the tone when it lied about its circumstances and lived beyond its means (see map and charts).

There is no disputing Greek dissipation, nor the fact that the euro zone's troubled members, which also include Portugal, Ireland, Spain and Italy, must now pay a heavy price. But those other troubled countries were not exactly profligate. Before the crisis the governments of both Ireland and Spain ran budget surpluses. Both meticulously kept within the limits for deficits and debts set down by the stability and growth pact—unlike Germany, which flouted the rules for four years from 2003 (and avoided punishment). Nor did Italy lurch into extravagance.

Debt in these countries has become a burden not because of government profligacy but because each enjoyed a decade of low interest rates and was then hit by the financial crisis. Easy credit fuelled debt in households and the financial sector. The European Central Bank oversaw a binge of cross-border lending. In the crisis unemployment and hardship have deepened, increasing the bill for welfare. Some countries, such as Ireland and Spain, have needed to find money to prop up their banks. These new expenses fell on the state just when tax receipts collapsed—catastrophically in countries that had seen a property boom.

At the same time interest rates surged. Before the crisis investors assumed no euro-zone government would default on its debt. However, as Peter Boone and Simon Johnson of the Peterson Institute in Washington, DC, explain, Germany then signalled that defaults could happen and that investors would have to bear a share of the losses—a reasonable demand, but a hard one to introduce in the middle of a crisis. Some investors asked to be rewarded for the extra risk and others, unwilling to start paying for credit research, just walked away. This set off a spiral of falling bond prices, weakening banks and slowing growth.



Even where troubled euro-zone countries had not been profligate, they have been running unsustainable current-account deficits. Low interest rates fuelled domestic spending and spurred inflation in wages and goods, which in turn made their exports more expensive and left imports relatively cheaper. But it was also because Germany was recycling the surpluses produced by its export machine, financing their consumption.

Germany's economy is remarkable in many ways, but it was as unbalanced as the euro zone's peripheral economies. In their determination to save, Germans seemed to forget that in the long run the point of exports is to pay for imports. They must now regret having invested their savings abroad in American subprime mortgages and Greek government debt.

Your Debt, Your Fault

To end the crisis, the euro zone members agreed last month to write down half of the Greek debt owned by the private sector, recapitalise Europe's banks and boost the fund created as a firewall to protect solvent euro-zone governments. It is an ambitious plan, but Greece may need even more help and the firewall does not look strong enough to withstand a bout of contagion.

And even when the crisis has abated, restoring Europe to health will take many years. That is because the troubled countries need to control their government deficits and to re-establish sound current accounts by improving their competitiveness. Germans feel that the responsibility for this lengthy adjustment lies exclusively with borrowers, which must urgently restore budget discipline. Significantly, the German word for debt, *Schulden*, is the plural of *Schuld*, meaning guilt or fault.

However, this strategy risks being self-defeating. By pushing for immediate austerity the euro zone is deepening recession in the troubled economies, which will only make their debt harder to service. Germany's approach suffers from a fallacy of composition. It is not possible for everyone to save their way to prosperity. As Keynes argued after the Depression, someone, somewhere must be consuming. In Europe that should be countries such as Germany and the Netherlands that were running vast current-account surpluses during the boom. But the creditors are loth to accept that they are part of the problem. Creditor governments, most of all Germany, face a dilemma. They need to save troubled governments in order to prevent contagion. On the other hand they also want to keep up market pressure for reforms and to establish the principle that governments are on their own—so that German taxpayers will not be landed with the bill every time some EU country goes on a spending spree. So far Germany is trying to have it both ways, and succeeding only in getting everyone deeper into the mire.

Destructive Creation

TIPOS INFAMES IS a fine bookshop in central Madrid, run by three young friends and stocked with the sort of books you were always meaning to read, until work and children got in the way. Well aware that the intellect needs gentle encouragement, the owners lure you in with strong coffee and generous glasses of Spanish wine. Running a bookshop is difficult, says "Curro" Llorca; these days he doesn't get so much reading done either. But business is passable.

Curro and his friends needed three years to set up shop. They had to obtain a full house of separate permits, one to sell books, a second to sell coffee and a third to sell wine. The town hall said not to worry and advised Curro to open his doors while he was still waiting for the paperwork. But the budding entrepreneurs wondered what they would do if the police turned up.

Tormented by unemployment, Spain needs new firms like Tipos Infames. Yet in the World Bank's ranking of how easy it is to start a business the country comes only 133rd, after Kenya.

Next to quelling the crisis, the single most important task facing Europe's economies is to grow, because only then will they eventually be able to pay off their debts. In order to do that, they need to improve their competitiveness. And the best route to improved competitiveness is to streamline the public sector and overhaul the markets for labour and services.

Yet Europe has failed for many years to accomplish just such structural reforms. Looking at Curro, the economic logic for change is unanswerable. But the politics is grim. Across Europe, business is held back by bureaucracy. Powerful interest groups are protected at the expense of everyone else.

The crisis only strengthens the case for reform. But it also means that reform must take place against the background of austerity, as societies struggle to determine who will shoulder the burden of debt. The darkening clouds of civil disobedience and anarchy confronting Greece's new government show where this struggle can lead. Europe's future depends not just on governments putting forward the right policies but on the capacity of democracies to bring about peaceful change.

How to gain in Spain

How might reform work? Again, consider Spain. Reform there should stand a good chance. The country has done well out of EU membership. After it joined in 1986, incomes caught up with the rest of the union. Its large exporters have remained an island of efficiency, as competitive as any in Europe. Spain recently signalled its commitment to the euro zone by writing a cap on future deficits into the constitution.

Moreover, the Spanish may be about to vote for change. An election later this month is likely to bring in a new conservative government under Mariano Rajoy of the People's Party (PP). If the opinion polls are to be believed, he stands to win a sweeping victory and to be able to govern with an absolute majority. Given that the PP also controls many of Spain's regions, Mr Rajoy will have an unprecedented mandate to remake Spain. "People know the PP is going to be severe," says José Ignacio Torreblanca of the European Council on Foreign Relations.

But what a task he faces. A prime target will be Spain's notoriously dysfunctional labour market. This provides a group of ageing, virtually unsackable "insiders" with gold-plated contracts, whereas the rest have to make do with highly insecure temporary contracts. Among other things, insiders benefit from wage-escalation clauses, so that in 2009 real pay rose by 3.2% even though the economy shrank by 3.7%. And Spain gives young people a terrible deal: in a downturn they are the first to be sacked. Not only are roughly half of under-30s out of work, but those who do have jobs are mainly on temporary contracts that leave them without a career structure and give firms no incentive to train them.

Mr Rajoy is elusive about his plans. The outgoing government has undertaken some labour-market reform, but most people expect the PP to go much further and doubt that the weakened Spanish unions will be able to put up much of a fight. But that is the easy bit. To transform the Spanish economy, Mr Rajoy also needs to take on two far more elusive foes.

First is the country's dense jungle of regulation and bureaucracy. This dates back to Franco, who from the 1950s sought to give Spaniards more freedom by trying to establish the rule of law even as he denied them democracy. The profusion of administrative law created a dense and unaccountable bureaucracy. Ignácio Sanchez-Cuenca, director of the Juan March Institute in Madrid, encountered so many obstacles to hiring academics from outside the EU for the institute that it took up a quarter of his time. So he hired a firm of lawyers to do the job and now spends 5-10% of his budget that way.

What makes Spain's bureaucracy especially poisonous is Mr Rajoy's second foe: the country's fiercely independent regions. Each tends to interpret regulations in its own way, so over time the Spanish market has fragmented. Juan José Güemes, a PP politician and a professor at the IE Business School in Madrid, explains how the star-rating system for hotels differs slightly across Spain, which limits competition among national and international chains and reduces economies of scale. Last year the Catalan government decreed that hotels must serve *pa amb tomàquet*, bread with tomato, a local speciality, if they are to count as "luxury". Miguel Cardoso, an economist at BBVA, a Spanish bank, estimates that, thanks to a lack of competition, half of the inflation in Spain over and above the average for the euro zone in the past 15-20 years came from firms increasing their margins.

Mr Güemes's colleague at IE, Fernando Fernández, adds that each of the regions sponsors its own development policy and its own businesses, often financed by local savings banks. This is inefficient, but the regions are popular because they spend taxes collected by the central government. Moreover, regional autonomy is an antidote to the centralising, anti-union bias of Franco's Spain. Even if the centre can control the regions' spending—a big if—"we have a free market at the national level and are protectionist at the regional level," says Mr Fernández.

Each reforming government in Europe faces different obstacles, but Spain is typical of them all in the sense that radical structural reform entails rewriting the social contract. Just now the generous wages of many of those in Spain's protected jobs are supporting entire households of unemployed spouses and grown-up children. Scrapping thousands of bureaucratic rules will not just make the economy more efficient but also recast the relations between government and citizen. However unambiguous the economics of reform, the politics is almost always hard.

Too hard for some. Rome alone is said to have half as many lawyers as the whole of France. The legal system there moves so slowly, Italians joke, that they put you in jail when you are accused and release you when they find you guilty. Yet faced with the liberalisation of their profession in a recent budget, Italy's lawyers somehow managed to hang on to their perks—was it because so many politicians are lawyers?

Instead of imposing reforms, the fag-end of a government under Silvio Berlusconi has relied excessively on tax rises. After he was shamed by euro-zone leaders during recent summits Mr Berlusconi at last came up with a more ambitious programme—but even then he was obliged to accept the supervision of the IMF. The mix of hopelessness and humiliation has left his government close to collapse.

Others have shown more courage. Ireland's government has cut wages and slashed benefits and services. Unit labour costs have fallen by 8% and the economy grew by 1.6% in the second quarter. The cuts have been even harsher in Estonia, where the economy shrank by 15% in 2009. Growth has soared since then and unemployment tumbled. Still, both economies face a hard slog. Because they are counting on foreign demand as a source of growth, they are vulnerable to a global recession.

The nightmare is Greece. Government there has never been about the rational design and administration of policy, but about dishing out patronage. When George Papaconstantinou, the country's finance minister at the time, was asked why tax receipts collapsed in 2009, the year his government came to office, he explained that "the first thing the government does in an election year is pull the tax collectors off the streets." Even so, the government of George Papandreou (in which Mr Papaconstantinou served) undertook reform with a savagery that would once have been unthinkable. He had a gun to his head, because the troika of the EU, the IMF and the ECB release aid each quarter only if the Greek government meets its targets.

Yet, beset by protests, a shrinking economy, the dishonour of being bossed around by foreigners and the prospect of a decade of further austerity, Mr Papandreou could not carry the country with him. He reluctantly resigned, following a botched proposal to hold a referendum on the euro zone's plans for Greece. The installation of a new government of national unity smacks of Argentina, where a succession of short-lived administrations fought to avoid default—before eventually succumbing.

Mr Papandreou's ejection contains a warning. At root, the solvency of a country is determined by the government's capacity to raise revenues and cut spending. Politicians run up against the popular will long before they run out of things to tax.

The crisis has also brought down governments in Ireland, Portugal and Slovakia. Spain, and others, are likely to follow. Where will voters turn when they have had their fill of austerity and reform? The lesson of the 1930s and of emerging-market crises down the years is that people can take only so much austerity. If the burden gets too heavy, the political system collapses.

This fear lies behind the warnings of Milton Friedman and Martin Feldstein, two American economists, who said that the euro is inherently unstable. Until recently euro-zone leaders scoffed at such talk. But in the past couple of weeks they have suddenly begun to contemplate Greece's departure from the single currency. And contemplation is one step short of action. Their change of heart is not just because of mayhem in Athens, but also because of the difficult politics of the euro at home.

In Theory
OVER THE PAST decade Europe's troubled economies have lost competitiveness against Germany, as the charts on page 4 show. Within a fixed currency they cannot devalue. Instead they need a combination of lower real wages, lower input prices and higher productivity. Higher inflation in Germany would make that easier. Structural reforms are hard, otherwise governments would have undertaken them long ago. But if countries continue to avoid hard choices, the adjustment will eventually be forced on them through recession and unemployment.

At the same time these economies must work off their debts. For the public sector, that can be through a combination of tax increases, spending cuts or growth. But it is hard, not least because Western societies have started ageing, which means that fewer people are in work paying tax and more in retirement claiming benefits. The IMF reckons that for the rich world's governments to take public debt back to 60% of GDP by 2030 they would need to improve their budget balances by a huge 8% of GDP by 2020. If governments fail to get their borrowing under control, then the adjustment will, again, be forced on the economy—this time by the bond markets.

Experience suggests that some policies are better than others. If you want to increase competitiveness, productivity growth is less disruptive than wage cuts, and wage cuts are better than unemployment. If you want the government to shift its fiscal balance, you should cut spending by roughly four times as much as you raise taxes. Growth is better than either tax rises or spending cuts—but, experience also suggests, growth after credit busts is scanty. The best recipe for growth is to raise productivity through structural reforms—but nobody said that was easy.

Beyond the Fringe
EUROPE HAS A dissonant new voice. Anti-Muslim, anti-elite, anti-globalisation and increasingly anti-Brussels, populists now count for something in the Nordic countries, among the Dutch and Flemish, in France, Italy and Austria, and in parts of eastern Europe. They come in many varieties, but all claim to represent what Pierre Poujade, France's original post-war populist, called "the ripped-off, lied-to little people".

These movements are sometimes described as neo-fascist. Some of them indeed are, and all of them embrace odious and intolerant views of one sort or another. But to dismiss them as fascist, and thereby safely rule them out of European political life, offers the liberal mainstream false comfort. Over the past few years populists have found ways to set themselves apart from a neo-Nazi ideology. Many support gay and women's rights (all the better, they think, to bash the Muslims), and many are fervently pro-Israel. They are here to stay.

Europe's populists are not likely to form governments; they lack the votes and are completely unequipped for office. However, mainstream politicians do not know how to see them off. So their obsessions and their resentments have seeped into the debate, even among those who would never vote for them.

This matters just now for three reasons. First, because the euro and its independent central bank are elite projects *par excellence*. The high priests of Europe's political class handed down the edict that Europe needed its own currency. They forced their economies to converge during the 1990s and masterminded the extravagantly complex job of issuing new notes and coins. Now that the technocrats have been shown up as bunglers, the anti-technocrats stand to gain. Second, populists are nationalists and protectionists and reject both the idea of paying to save Europe's troubled periphery and the sort of structural reforms that Europe needs for growth. And third, populists feed the widespread mistrust of Brussels and all its works, which will constrain the options available to fix the euro.

To understand how populism has taken root, look at what has happened in the Netherlands, once the very model of a tolerant, pro-integration member of the EU. In his study of the murder of Theo van Gogh, a film director, by a radical Dutch Muslim in 2004, Ian Buruma borrows the term *regenten* to describe the modern Dutch elite. Like the self-confident 17th-century ruling class of merchants smugly gazing from the portraits of Frans Hals, the 21st-century *regenten* looked out for themselves and neglected the things that bothered ordinary people.

In the Netherlands the beef was with the immigration that created "dish cities" of Turkish and Moroccan households tuned to satellite television from abroad. The *regenten* were all in favour of multiculturalism and in no hurry to press immigrants to assimilate. In the early 2000s a flamboyant gay university lecturer called Pim Fortuyn made a political career out of condemning what he saw as Muslim intolerance and *regenten* neglect. What did this have to do with Europe? At first, nothing at all. But after Fortuyn, too, was murdered in 2002 (by an animal-rights activist, not a Muslim), another Dutch politician, Geert Wilders, took up his cause and increasingly exploited popular resentment against the *regenten* project of European integration.

As the EU has grown from six to 27 countries, the Dutch, who were among the founder-members, have felt their influence drain away. They have gone from being beneficiaries of European funds to net contributors. They feel they have had to take in migrant workers from eastern Europe who threaten their jobs. Sometimes the EU has imposed unpopular decisions, as when it ruled that the distinctive, often religion-based Dutch housing associations were discriminatory, or that Turks were exempt from a mandatory exam for immigrants because Turkey is an official candidate for EU entry.

The extent of anti-European sentiment became clear back in 2005, when the Dutch voted in a referendum to reject a proposed new constitution for the EU by a crushing 62% to 38%. It was the first time the Dutch elite had condescended to ask ordinary people about Europe and, says André Krouwel, a political scientist at Amsterdam Free University, even people who had nothing against Europe found something in the constitution to dislike.

With Mr Wilders's Freedom Party on one side and the anti-globalisation Socialist Party on the other, the pro-European, pro-globalisation middle is being squeezed out of Dutch politics. The centre parties used to win 80-90% of the vote. In the most recent election they got only 54%. Meanwhile, the tweeting Mr Wilders, whose party has just 16% of the seats in the Dutch parliament, manage to grab 40% of the media coverage of politics, reckons Mr Krouwel. “He has destroyed Dutch consensus democracy,” he adds.

A similar story is emerging across Europe, though the details differ. The True Finns are more Eurosceptic than anti-Muslim; the Danish People’s Party and the Sweden Democrats are obsessed by immigration; Italy’s Northern League is consumed by contempt for Naples and the feckless South, as well as immigrants and the EU; Belgium’s Vlaams Belang stands for Flemish independence; France’s National Front is being dragged away from its fascist, anti-Semitic past by Marine Le Pen; Hungary’s Jobbik has not even begun to change out of its jackboots.

But the punchline is the same. Heather Grabbe of the Open Society Institute in Brussels calls it “the politics of resentment against elites”. This sentiment makes office a dangerous place for populists. After Jörg Haider’s Freedom Party won 27% of the vote in an Austrian election in 1999 it joined a coalition government, but in the 2004 elections to the European Parliament it got only 6.3%. Out of power, the Austrian populists (now split into two parties) saw their overall strength recover to almost 30% of the vote within just four years.

These days populists prefer to stand half-in and half-out of government, where they can claim credit for policies on, say, immigration even as they disown the difficult decisions that ministers often have to take. That was the strategy of Pia Kjaersgaard’s People’s Party, which put its stamp on immigration policy in Denmark until the election of the Danish left in the summer. These parties talk tactics with each other, says Sarah de Lange of the University of Amsterdam. And so the Danes have been copied by Mr Wilders, pictured above, who supports a Dutch minority government but is not part of it.

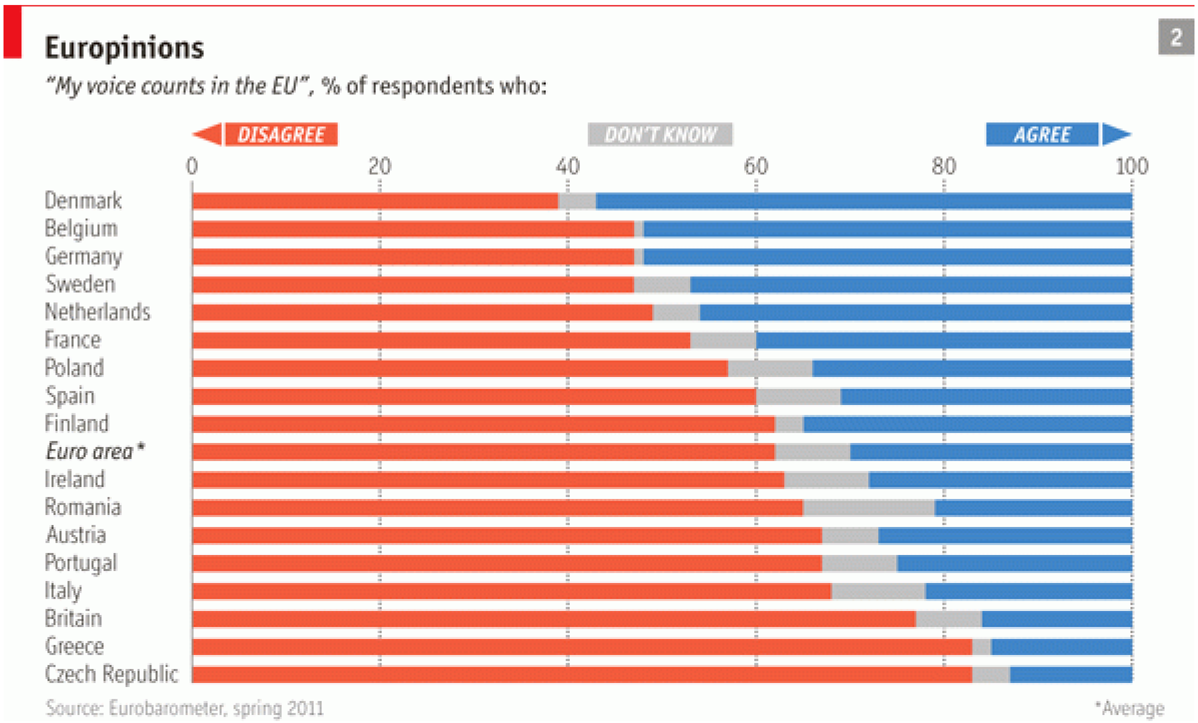
The Dutch finance minister, Jan Kees de Jager, says that this leaves the Dutch approach to Europe unscathed. The government can pass legislation on the EU by calling on the support of the opposition centrist parties, depriving Mr Wilders of influence. That line is supported by surveys showing that the level of Dutch backing for “Europe” in the vaguest, most generalised sense has not dramatically fallen over recent years.

But this argument is not wholly convincing. Dutch attitudes to sovereignty have hardened. Politicians come back from Brussels to The Hague complaining that they could not get the deal they wanted. The idea of spending Dutch money to rescue the Greek economy was unpopular. If fixing the euro required another referendum, the government would struggle to win.

Don’t look for gratitude

Moreover, that Dutch vote against the European constitution was part of a Europe-wide popular backlash against the EU. The constitution was supposed to renovate the EU’s creaking legislative machinery as well as bringing Brussels closer to the people. But the people either did not understand it or were not interested. Having been rejected in France as well as the Netherlands, the constitution was reworked as the Lisbon treaty and was at first rejected again, this time by a referendum in Ireland. The treaty-cum-constitution limped into law in 2009, eight difficult years after work on it had begun. The instrument intended to fortify the EU with popular legitimacy won just three out of six referendums. Ten governments had backed away from promises of popular votes.

The message is clear. However unpleasant some of the populists' views are, they are on to something with the EU. Ordinary Europeans see Brussels as remote and elitist (see chart 2). As it happens, the European project was like that from the very beginning—and for the best possible reasons.



Look back to the founding of the European Economic Community, the EU's forerunner, in 1957. What from the vantage point of 2011 might seem like an undemocratic fix was actually inspired statecraft. After the second world war many Europeans feared that the ghastly cycle of economic depression, instability and war was going to begin all over again. They were caught between the horror of German revanchism and the nightmare of a communist takeover. Europe was the antidote to the madness that had almost destroyed Western civilisation in two world wars, and it was to be administered by the *regenten* of the day. The architects of the EEC did not seek to harness popular enthusiasm, because it was such enthusiasm that had led to Fascism and Bolshevism.

No wonder that EU business has always been more about the horse-trading of the committee room than about the rhetoric of the debating chamber. David Marquand, a former British MP and a commentator on Europe, writes: "At the heart of the European project lay an unacknowledged but pervasive ambivalence about politics. In transcending the nation state, the founding fathers were also seeking to transcend—or rather to escape from—the messy, vulgar, clamorous irrationality of political life."

Inspired by the quest for peace, Europe's designers expected their creation to be justified by what the Brussels officials still call "output legitimacy"—that Europeans would accept the EU because it worked. But that is not what has happened. Today's Europeans take peace for granted. They are more inclined to measure the EU by the prosperity it has brought. However, it does not get the full credit for that either because national politicians, instead of explaining how much the EU has contributed to Europeans' wealth, take the credit for themselves. And many of them like to blame Brussels for everything that is bad.

The EU has not helped its own cause. Terms like "the community method", "Coreper" or "co-decision" seem almost designed to scare people off. Its processes are comically obscure. Paul Magnette, a Belgian politician, reckons that there are 22 different legislative procedures and 30 legal instruments for decision-making in the EU—and that is only counting what is known as the "first pillar" of EU competencies (don't ask).

All this has led critics to complain about the EU's "democratic deficit". But that line of attack is off-beam. The commission (which is unelected, but must be approved wholesale by the parliament) can only propose legislation and help to enforce it. New laws need the backing of ministers from national governments and the elected European Parliament. Compared with national capitals, Brussels is admirably free with information and briefings once you penetrate the jargon and the procedure.

What the EU lacks is not democracy but popular engagement. It always has and it always will. There is a small industry churning out suggestions for how to remedy this. How about directly electing the commission's president? Or sending national MPs to sit part-time in the European Parliament? Or staging Europe-wide referendums, so that a single country cannot hold the other 26 to ransom? None of them would change the fact that the EU is remote, impenetrable and elitist. However hard it tries, the EU will not be loved by European citizens—even those who are broadly pro-European. In the words of Anand Menon, a British academic, it is "structurally condemned to inspire apathy".

"Public opinion is a new actor in the EU," says Charles Grant, director of the Centre for European Reform. "It limits what technocrats can do." Beset by populist anti-elitism on one side and impenetrable technocracy on the other, the fate of the euro therefore lies squarely in the hands of national governments. And none more so than the duo that have long made the running in Europe, France and Germany.

The Nico and Angela Show

WHEN DE GAULLE'S foreign minister asked him which officials France should dispatch to Brussels to staff the new European Commission, the general replied: "Send the most stupid." Although these days France installs some of its best people in Brussels to watch what the EU gets up to, that condescending attitude has never entirely disappeared. If it had a choice, France would keep the commission firmly in its place and run the show with Germany as a sort of European G2, but enlargement of the EU to 27 countries got in the way. The euro crisis presents France with the best chance in decades to drag the EU back on track.

At the same time, though, the crisis has established a new German dominance in Europe. As the continent's biggest economy, Germany has set the terms of the various euro-zone rescues. Having largely absorbed east Germany since unification in 1990, it is looking for markets in the emerging economies. And, bit by bit, it is carving out a more assertive and independent role.

When Nicolas Sarkozy, France's president, meets Angela Merkel, Germany's chancellor, the atmosphere can be chilly. Ms Merkel has said she thinks she is "the most boring person Mr Sarkozy has ever met". But what matters more is the unresolved combination of France's designs and Germany's power. Their difficult partnership weaves yet another strand into the drama of the euro, adding to the uncertain future of the EU itself.

The blues in Berlin

During the euro crisis Ms Merkel has often seemed torn, refusing such things as a concessionary interest rate for Greece, only to change her mind later. That partly reflects her temperament: cautious, tactical and naturally inclined towards the middle path between standing firm and coming to the rescue. But, to be fair to Ms Merkel, it is also because Germany itself is torn.

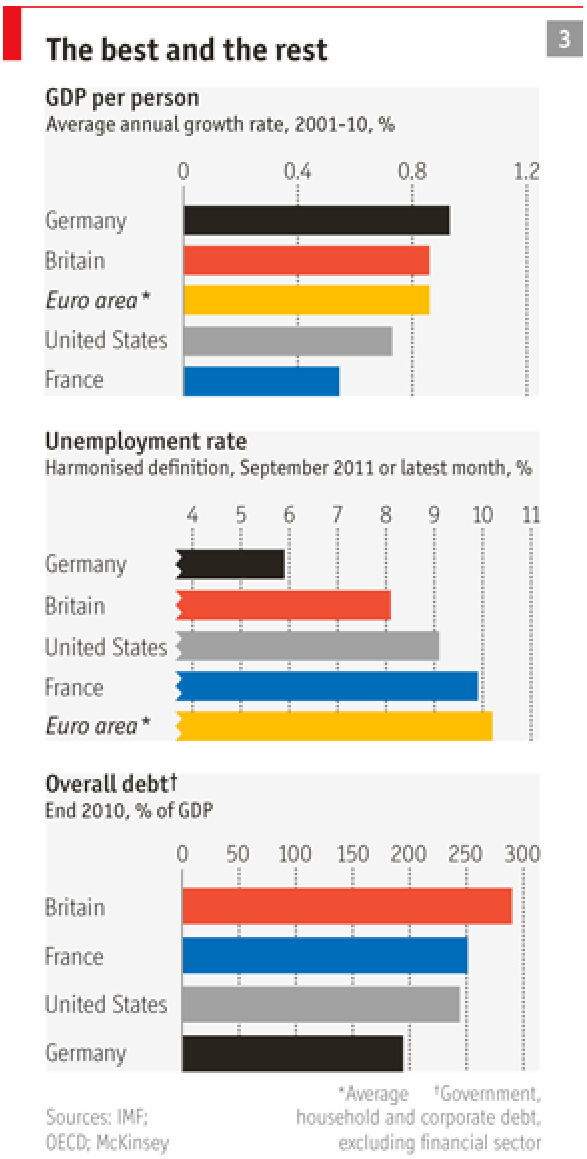
On the one hand, Germans know that their fate is still bound up with European integration, as it has been for the past 60 years. The country's pro-European finance minister, Wolfgang Schäuble, says that although Germans might be sceptical of the euro, they are not Eurosceptics. Opposition parties have criticised Ms Merkel for being too reluctant to save the euro zone. They have put forward bold plans, such as Eurobonds issued jointly by the entire euro zone, combined with a leap in fiscal integration. The opposition has been rewarded with a strong performance in regional elections. By contrast, Ms Merkel's party has suffered at the polls and her coalition partner, the more Eurosceptic Free Democratic Party, is on its knees.

Moreover, the German economy is intricately tied into the European economies around it: they are a source of parts and supplies for German industry, a place where German banks and insurers have invested their savings, and a market for German goods. A collapse of the euro or a chaotic default by a European government or bank that spread through the EU economy would be a terrible outcome for Germany.

On the other hand Germans also feel indignant. They think that at the time of monetary union they were conned with the false promise that the euro and the European Central Bank would be worthy of the mighty D-mark and its guardian, the Bundesbank. These were potent symbols of German nationhood. As Helmut Kohl, chancellor at the time, told the then French president, François Mitterrand: "The D-mark is our flag. It is the foundation of our post-war reconstruction. It is the essential part of our national pride; we don't have much else."

The euro is no D-mark. Day after day German television and newspapers portray Europe as a threat to German prosperity. The "no bail-out" clause, designed to ensure that governments will not be held liable for other countries' debts, has been trampled underfoot. As the crisis has grown, the share of Germans who think the euro will be a long-term success has fallen from 78% in 2008 to 55% earlier this year. Ordinary Germans are asking if they should ship their savings to Switzerland.

And, in German eyes, the ECB is no Bundesbank. When the bank proposed to buy bonds of troubled governments in the open market, two Bundesbank vigilantes objected, arguing that the policy took the ECB across the threshold from monetary to fiscal policy. Having lost the argument, they resigned. At the end of last month the Bundestag passed a non-binding resolution against the ECB's financing the euro-zone rescue fund or continuing to buy bonds once the rescue fund can do so instead. Jörg Rocholl, dean of the ESMT business school in Berlin, talks of a "common feeling of betrayal" over the ECB.



When Germans look at Europe's periphery they see economies that partied when they should have been sobering up. After unification Germany put itself through economic boot camp. The unions agreed to lower pay rises. The government cut benefits, raised charges and made it harder for workers to claim disability allowances. Between 1994 and 2009 the country's unit labour costs fell by about 20% against the rest of the EU. But the adjustment was a hard slog. Jobs went abroad, where labour was cheaper, and unemployment rose to a peak of 12.1% in 2005. That same year the Social Democrat-led government of Gerhard Schröder paid the price at the polls, bringing Ms Merkel to power.

Yet, thanks to these efforts, Germans have enjoyed world-class economic performance over the past decade (see chart 3). No wonder, then, that they resent seeing the fruits of their own self-denial being used to pay for everyone else's self-indulgence. In any case, Germans have never quite got over the anxiety that they developed in those years of austerity. Whereas the rest of Europe looks at Germany and sees an economic powerhouse, many younger Germans doubt that they will live as well as their parents do, and fret that the social safety net will not be there when they need it.

There was a time when Germany bore its financial contributions to the EU with stoicism. Uwe Kitzinger, a British academic and former official in Brussels, called them “a form of delayed war reparations”. But now the country is making its anger felt.

“As the pivotal state in monetary union,” writes David Marsh, “Germany is becoming more self-centred but less sure-footed, more hectoring but more vulnerable.” Mr Schröder put down a marker back in 2000. At a summit in Nice he demanded that in ministerial votes on EU legislation Germany’s large population should have a bigger say than other countries. Last year the Bruegel think-tank in Brussels published an essay entitled “Why Germany Fell out of Love with Europe”. And Jean-Claude Juncker, the prime minister of Luxembourg and head of the Eurogroup, in which the euro-zone’s finance ministers meet, complained that the “Germans are losing sight of the European common good.”

Moreover, the world is changing. German trade has been shifting away from the euro zone. In 1999 German exports to Portugal, Ireland, Spain and Greece totalled €30 billion, a multiple of those to China, just €6 billion. By last year exports to China, worth €53 billion, exceeded those to the four peripheral economies. Goldman Sachs, a bank, reckons that China is poised to match France as Germany’s biggest trading partner.

And Germany, too, is changing. Its controversial decision not to join France and Britain in the NATO campaign against Libya’s Muammar Qaddafi represented what Constanze Stelzenmüller, of the German Marshall Fund, calls “a loosening of the ties”. NATO, she says, is no longer bound by the “unifying energy of the Russian threat”.

Reflecting on Germany’s strife over the euro and its refusal to fight in Libya, Hans Kundnani, editorial director of the European Council on Foreign Relations, recently argued in the *Washington Quarterly* that “Germany’s economy is too big for any of its neighbours, such as France, to challenge…but not big enough for Germany to exercise hegemony.” This, he concluded, is an economic statement of the “German question” that tormented Europe for 75 years after German unification in 1871.

The most likely answer to that question today is compromise. Germany is not about to walk away from Europe, nor to let the euro fail. But Germany’s price will be a rescue in which it will be explicitly seeking to put its own interests above all others. What does that mean for France?

The Pressure in Paris

Thanks above all to De Gaulle, France has been fabulously successful in Europe. Having been defeated and occupied by Germany, France was humiliated and neglected by America and Britain. In 1954 Eisenhower called the French “a helpless, hopeless mass of protoplasm”. But armed with the general’s brilliant combination of cunning and self-belief, France made itself indispensable to the construction of Europe. It then used that status to tame the German threat, to project French power in the world and to get the EU to pay for its own expensive farm subsidies.

But that policy has run its course. A senior French politician says that today's Franco-German coalition "is fragile and public opinion is hostile". In French eyes today's EU suffers from three flaws. First, the commission and the ECB have too much scope to act independently of governments. Second, the British-backed policy of enlargement has gradually changed the character of the union, making it harder for French views to prevail and over-emphasising open markets. And third, taking Mr Kundnani's German question, France needs to renew its deal with Germany.

The euro crisis offers a tantalising chance to do so. Because the euro will need more and better governance, France has an opportunity to sideline the commission by creating new institutions controlled by governments. If decisions can be taken by the 17 members of the euro zone, rather than the 27 of the EU, then the restored Franco-German duo might take charge.

France has already made progress. Throughout the euro crisis Mr Sarkozy has appeared alongside Ms Merkel at Franco-German summits to set policy for the entire euro zone. His reward was that the euro zone will have two summits a year and its own secretariat. Germany has seemed willing to fall in with the French preference for an intergovernmental "*Europe des patries*".

Yet even if the other 25 countries in the EU are ready to go along with this, France faces a huge obstacle. To be an equal partner, it has to be a plausible match for German power. "Ideas can come from France only if it is economically strong," says André Sapir, of the Bruegel think-tank. France's military force helps, but the economy lets it down. Moody's and Standard & Poor's have both warned that they might cut their rating of French government debt, alarming the government in Paris.

The economy's problems run deep. French industrial exports have fallen from 55% of Germany's in 2000 to around 40% now. Fewer than a third of France's industrial companies spend money on R&D, compared with almost half in Germany. And although France's government finances are fairly healthy compared with those of many other rich countries, the markets doubt the country's long-run capacity to pay its way.

Demography is on France's side: its population is growing, whereas Germany has one of the EU's lowest fertility rates. Yet the trajectory of government borrowing raises concerns, given that in 1980 France's debt was only 20% of GDP (see chart 4). The public sector's share of the economy is already greater than Sweden's, which limits the scope for tax increases. Mr Sarkozy's government reformed pensions last year, the first increase in working time in France since the second world war. However, the change put the minimum retirement age back by only two years, to 62, and it met with huge resistance. The Socialists are promising to reverse it if they win the presidential election next year.

Jean Pisani-Ferry, a director at the Bruegel think-tank, points out that the French are ambivalent. Although they are creditors, the media have covered the Greek crisis very differently from the German ones, emphasising the suffering of ordinary people. “The French see a magnified version of their own failings,” he says.

Germany still needs France to get things done in Europe. If Paris and Berlin can agree on a policy then most of the other countries will rally round. But in the recent summit talks over a euro rescue, France gave way to German demands—notably that the ECB should not lend to the rescue fund. The risk for France is of becoming a foil for Germany rather than a genuine partner.

In the 1990s France qualified for monetary union by clinging doggedly on to the strong franc, even as others devalued. Some of those who run France readily acknowledge that they need a similar act of will today. “Politicians have not told the French people the truth,” says Bruno Le Maire, the French agriculture minister. “We said there was no need to change. It’s false…France has to accept the world as it is…We have to give Germany the idea that we can succeed with the market, not with a protected Europe.”

Look at it This Way

EVERY COUNTRY SEES “Europe” as a projection of its own hopes and fears. For Germany it is redemption; for France a means to amplify French power; for Italians it is not Rome; for Belgians it is not Brussels; for the Baltic states it is a long way from Moscow; for Romania and Bulgaria it is order; for Spain it is the solution; and for much of central Europe it is home.

The rest of the world has a stake in what happens in Europe, too. The overwhelming feeling is frustration that European leaders seem so incapable. Andrew Balls, of PIMCO, the world’s largest bond investor, says that the difference between emerging-market crises and G10 crises has always been that you expect G10 governments to remain in control. After a series of half-rescues of the euro, he wonders whether this rule still applies.

It is a sure bet that at crucial moments America will be on hand to browbeat Europeans into taking action. The Federal Reserve will stand by to back the European Central Bank. Neither wants to see the world economy dragged into recession by European blunders. But America has enough troubles of its own.

The idea that China might become a dragon ex machina, spending hundreds of billions of dollars on the bonds of troubled European governments, is fantasy. China will offer encouragement. It may invest in the euro zone's new special-purpose vehicles to buy the debt of troubled euro-zone governments—with the right political concessions, it may even be generous. But the amounts of hard Chinese cash will be limited, if only because the euro zone's creditor nations were unwilling to put more of their own money into the pot.

The Ins and Outs of Being In

Within the EU, the crisis is a test of the European dreams of countries that are not part of the euro zone. Many of them are relieved to have escaped the turmoil. But they are now in a spot. If one day they surrender their own currencies, as in theory they pledged when they joined the EU, the revamped governance of the euro will affect them deeply.

Take Poland, by far the biggest economy among the former communist countries and still outside the euro zone. It has had a good crisis, being the only EU country to avoid a recession, at least so far. That is mostly because of domestic demand, but also partly thanks to its ability to devalue the zloty.

And yet mainstream opinion in Warsaw is in no doubt that the nation's destiny is tied to the euro, and particularly to Germany. That is partly an economic calculation. Germany is a vital export market for Poland. Its components and parts help make German industry competitive. Ryszard Petru of demosEUROPA, a think-tank, argues that being part of the euro would help ensure that foreign direct investment (FDI) keeps coming. It has been very important in modernising the Polish economy, but remains relatively low.

The Polish establishment also thinks that the euro makes political sense. Although the country started as fiercely Atlanticist after communist rule came to an end, it is now somewhat disenchanted with the United States. When Barack Obama cancelled the Bush administration's missile-defence shield (which would have protected Poland) in 2009, he chose a fraught date: September 17th, the anniversary of the Soviet invasion of Poland in 1939. Poles felt slighted, even though the system's replacement turned out to be bigger and better. They also think they were not properly rewarded for their support of America in Iraq.

As the idea has gained ground that the euro zone might form an EU inner circle, so Europe itself has come to seem more important to Poland. "It is not just tactical," says Aleksander Smolar of the Stefan Batory Foundation, a think-tank. "For 1,000 years we have been trying to get into the real Europe, Charlemagne's Europe. Many times we have failed."

Politicians are quick to say that Poland "has no problems with tighter discipline and budget control". They point out that the Polish constitution already says government debt should not exceed 60% of GDP—one of the criteria of the EU's much-abused stability and growth pact. Polish officials still have fresh memories of their country's EU accession, when they were bossed around and told to shape up. After that, a dose of euro-zone discipline might not seem too irksome.

What does worry Poles, though, is any hint that their country might lose influence. The normally equable Donald Tusk, Poland's prime minister, flew into a rage in February when his country and the other nine euro "outs" looked as though they might be excluded from the "competitiveness pact", a German scheme to help integrate the 17 economies in the Eurogroup. Mr Tusk won a reprieve, with a promise that the outs could join in a special "euro plus" group. But this may not add up to much: the real decisions may still be taken by the 17 euro members. In the end, if Poland wants to be confident of making its voice heard, it will probably have to take the plunge and apply to join them.

They see things differently in Britain, and to a lesser extent Denmark, both of which have formal exemptions from joining the euro—though Denmark's currency is pegged to it. The dominant emotion among Eurosceptic Britons is not sympathy for their main trading partners but fury that Britain is being dragged down by what they see as continental Europe's failure.

Blighty and Bluster
Under the Conservative Party, the senior partner in the ruling coalition with the pro-European Liberal Democrats, Britain is fast drifting off into the Atlantic Ocean. Many Conservatives would like to use a new treaty on the euro, agreed on among all 27 EU members, as a chance to put some British business onto the table. One group of Tory MPs has suggested repatriating powers over criminal law, social policy, financial regulation, farming and fisheries. These are not fringe voices: fully 81 Tory MPs defied their party to vote against the government in a recent bill calling for a referendum. In a continent full of visions of Europe, none is more jaundiced than Britain's. But even allowing for that, the Conservatives' scheming looks bafflingly complacent.

The crisis could profoundly affect British interests. The euro zone represents over 40% of Britain's trade. London is the EU's biggest financial centre. And senior officials in Brussels think the Eurogroup could well become a place where important business is done, to the disadvantage of outsiders. "I see a real danger of Europe splitting," says one. Resented all over the continent as a bad European citizen, Britain should not expect any sympathy if the agenda turns against it. When you ask euro-zone politicians about British interests, they say: "If Britain is worried, there's an easy solution. It should come into the euro."

Tory MPs think they hold all the cards, because they calculate that the euro zone needs British backing to reform the EU's treaties. In fact Britain's hand is weak. Rather than give in to British demands to repatriate powers, the 17 euro-zone countries could just sidestep London and sign a treaty outside the EU.

The Tory desire to strip down relations with Europe, as if Britain might become a giant Norway or Switzerland outside the club, makes no sense either. Britain is too big to be left alone by the rest of the EU. At risk is the single market. Not only is it the most important EU institution for Britain, but without Britain's liberal voice it may well veer towards protectionism.

Making Do

IN THE HEART of the EU's administrative district in Brussels, a little way inside the council building where EU ministers hammer out legislation, stands a big bronze bust of Justus Lipsius. A 16th-century humanist who sought to reconcile Christianity and Stoicism, Lipsius betokens learning and integrity.

On closer inspection, though, the bust turns out to be made of painted plaster. If you rap it with your knuckle you hear the thwack of gypsum rather than the ring of cold metal. Low down on the great scholar's mantle is a small white patch where the paint has chipped away. Far from adding dignity to the business of the council, the mock-bronze inadvertently honours the Brussels tradition of making do. It is this spirit of grubby compromise, not lofty idealism, that will determine the future of the euro.

That is because, as Joseph Schumpeter argued, a monetary system cannot be separated from the society that underlies it. Saving the euro is about much more than the optimal design of a currency area. Even as the euro zone fights to steady its banks and its sovereign borrowers, it must grapple with the profound choices that this special report has set out.

Four Choices

The most important of these is Europe's attitude to globalisation. The more the euro zone embraces growth-enhancing reform, the lower the chance that its members will, after years of grinding austerity, succumb to the political fatigue that could lead to the euro's collapse. However, the economic imperative for austerity and restructuring is already putting the governments of the euro zone's troubled periphery under severe strain.

A second choice is about what it means to be "European". Among the euro zone's creditors, populist parties are increasingly rallying against the EU. Battered by austerity, the citizens of debtor countries could easily go the same way. Elites all across Europe have lost their authority. The European Commission and the parliament tend to be resented by national governments. All this limits the scope for fixing the euro by transferring sovereignty to Brussels.

A third is about the leadership of Germany and France. The crisis has given the leading role in Europe to Germany. It must decide what price it is willing to pay for leadership and how to use its new power. Will it come round to the idea that the European Central Bank (ECB) must put its balance-sheet behind the euro zone's governments? Meanwhile, France, greedy to redesign Europe according to its own tastes, must decide whether it is prepared to take the difficult steps needed to keep up with Germany.

The fourth is about Europe’s divisions. Eastern Europe is anxiously watching the confusion and disarray to its west. It must choose whether its destiny should eventually be inside the euro. Britain, too, must work out what it wants from the EU. In the past it has yanked the continent towards open markets and economic liberalism. Today Britain is striding away from Europe in a very British fit of absent-mindedness.

These questions are complicating the rescue of the euro. In the crystalline world of political and economic theory the immediate task is to stop the run on Europe’s banks and sovereign borrowers. This requires a controlled default of insolvent governments—which, so far, means Greece—and the protection of solvent governments by a pledge to buy as many of their bonds as it takes to ward off market panic. At the same time Europe’s banks must be protected with fresh capital. The euro zone showed at last month’s summit that it is coming around to this design—though the package they came up with was still too puny. But the two other components of any complete euro rescue are still embryonic.

One is reform of the euro’s governance. The euro zone needs a fund that can help member states cope with shocks. More ambitiously, the credit rating of the entire area might be used to issue Eurobonds, which would be less vulnerable to speculation. The euro zone must ensure that delinquent borrowers do not exploit these facilities to run up bills for everyone else to pay. And, to block the vicious circle in which failing banks amplify the weakness of sovereign borrowers, it must establish a European mechanism for insulating banks from their sovereigns.

In theory all this is possible. In practice, however, it would involve a large transfer of sovereignty to give the central euro-zone authorities the scope to raise money, regulate banks and prevent errant fiscal policy. Few countries are ready for that. The prospect of a United States of Europe is about as real as the bronze of Justus Lipsius’s bust.

For a start, Germany and France will not allow the European Commission to gain much extra power. In recent years Germany has become suspicious of the institution. Neither Ms Merkel nor Mr Sarkozy is fond of José Manuel Barroso, its president. The money for the euro-zone rescue pot, the European Financial Stability Facility, has come from the member states, mostly from France and Germany. They are not about to hand control over hundreds of billions of euros to the commission.

One alternative might be to fix everything among governments, in the Eurogroup, as France would wish. But smaller countries have seen, in the treatment of Greece and Italy, how France and Germany get to call the tune: “intergovernmentalism” leaves them vulnerable. And Germany’s federal constitutional court in Karlsruhe ruled after the 2007 Lisbon treaty, the EU’s most recent piece of constitutional re-engineering, that the German government could never again transfer sovereignty away from the German parliament to Brussels without also ensuring that German citizens have more say at the European level. Deals among a roomful of governments do not meet that test.

What about the German idea to give more power to the European Parliament? Many national governments would object. How would Nicolas Sarkozy, emperor of the Fifth Republic, feel if the European Parliament had more sway over him than his own tame Assemblée Nationale?

In short, there is no consensus in the euro zone for an ambitious transfer of sovereignty to Brussels. Instead, in the spirit of shoddy compromise, it will do as little as it can. As the summit in October hinted, the emphasis will be on binding countries by the norms of prudent economic management—a supercharged version of the set of rules the commission presented a year ago, including warnings about imbalances and fiscal sustainability.

Perhaps such rules could be enshrined at national level. Just as euro-zone members are required to have an independent central bank, they could be obliged to set up independent offices of statistics and budget sustainability and to enact constitutional guarantees of good behaviour. That would provide euro-zone reassurance without euro-zone sovereignty. Perhaps, too, banks could be regulated at the EU level and be prevented from ever becoming as dependent on their sovereigns as they are today.

All this will need to be backed up by strong discipline—and that will lead to yet more trouble. France would prefer the stick to be wielded at the discretion of governments. Germany, however, wants binding rules and strong punishments. Germany is likely to carry the day, but only if it can find a way to force through a new treaty.

That will be harder than it sounds. A full treaty requires a convention, an intergovernmental conference and then ratification by national parliaments and a referendum in Ireland and quite possibly in other countries, too. Old Brussels hands think that all this would take three to four years. Moreover, the mood in Ireland just now is so bad that you could not get the ten commandments approved in a referendum.

Scarred by the difficulties of trying to write and ratify a constitution for the EU, the euro-zone countries may therefore try to dress up a treaty as merely a “technical” adjustment. They may try to sign a treaty among themselves, outside the EU. That would stop Britain from causing trouble, and negotiations among 17 countries may be speedier than among 27. However, existing EU law requires the new agreement to mesh with all other EU treaties, which may be awkward.

From an economic point of view such minimal new rules for governing the euro would be second-best. Despite what is often said, no economic law dictates that a common currency must have a common fiscal policy. But fiscal co-ordination does make life a lot easier.

The price of a cobbled-together rescue is that some day the euro zone will probably have to endure yet another existential crisis. It is all very well to talk of discipline and oversight right now, when disaster is still an imminent possibility; but wariness is bound to fade with time. Bubbles inflate precisely because people fail to recognise that they are living with dangerous imbalances. One French official remembers being told by commission economists during the boom to copy Ireland and Spain. Now the same people are telling him to copy Germany.

Postwar Postscript

The third component of a textbook euro rescue would rebalance Europe's dangerously lopsided economies. In the troubled countries of the euro zone this requires a programme of thoroughgoing structural reforms, along with a plan to reduce government budget deficits over the medium term. The euro zone's creditor states would match this with a fiscal stimulus designed to boost demand in their economies. That would help drag the ailing members out of recession.

Again, reality will fall far short of this ideal. The citizens of uncompetitive economies are already exhausted by austerity, and Germany and the other creditor nations are reluctant to run deficits. The danger is that people will refuse to accept the unemployment and austerity being imposed on them. If so, that will hugely raise the economic damage wreaked by crisis, as yet more output is lost and more jobs are destroyed.

This is the greatest single threat to the survival of the euro. Governments will topple and the programmes underpinning international aid will fall apart. An angry, populist Greece might well storm out of Europe as a harmful act of protest. At that moment the risk of contagion would be at its greatest. Would the single market survive? Would the ECB and Germany, staring into the abyss, at last commit themselves to ring-fencing solvent governments?

Sometimes the worst really does happen. However, even if Greece goes, a general fragmentation of the euro zone remains unlikely. Collapse would not benefit any of its members. Even if joining was a mistake, quitting would be a bigger one. Moreover, all the arguments over rescue funds and bank bail-outs are in the end about who will pay, not whether the system is worth saving.

The brinkmanship could go on for months and there might be more half-rescues like the one in October. But were a bank or a solvent economy suddenly to fall prey to a market panic, then governments and the ECB would surely step in. It would make no sense for the ECB to put its own reputation for orthodoxy before the ravages of deflation. And if the euro zone ceased to exist, the ECB would have nothing to be orthodox about.

Remember, though, that even this action would only buy time for Europe's troubled economies to resume the relentless slog of regaining competitiveness and working off their debts. Sometimes you read that such an enforced workout is a hopeless cause. Ageing, comfortable Europeans have no stomach for hard work or invigorating globalisation. Many governments will want to protect their companies, not subject them to competition. The temptation to use the euro zone to defend unaffordable privileges will be strong. The political culture in a country like France has long seen globalisation as a threat to be managed. That view may be hard to shift.

Yet this argument is too fatalistic. Europe has a choice, just as America had a choice after the miserable decade of the 1970s, when it decided to beat inflation and re-establish the dollar. Europe has much to offer: creativity and imagination, skills in design and manufacturing, expertise in science and engineering. And it has something to prove to an interconnected world. Confronted by global finance and business, no political system seems able to cope alone. If collaboration cannot be made to work among the states of Europe, bound by history and culture, can it work anywhere?

This newspaper's fervent hope would be that Europeans embrace globalisation by at last getting serious about reforming their rigid economies and their welfare states. Indeed, the present crisis has presented them with a unique chance to break apart the political interests that have held them back.

Crises have a way of speeding up history. In his magisterial account of Europe after 1945, Tony Judt writes: "Postwar in Europe lasted a very long time, but it is finally coming to a close." The near-failure of the euro has made Judt's world seem more remote than ever. The post-Nazi taboo on populist parties is falling away. Without the Soviet Union's occupying armies, Germany is once again the power that leads Europe but is unable to dominate it. The bloodless politics of Brussels, once a bulwark against extremism, has now become an obstacle. The welfare state, built on postwar prosperity, has become too expensive for these straitened times.

It is often said that in the face of the euro crisis the EU must either integrate or disintegrate. Either is possible. More likely, though, it will muddle through, integrating as little as it can get away with, disintegrating as Britain becomes ever more detached, and reforming just enough to get by. When the fuss is over, the chances are that Europe will breathe a sigh of relief and continue rather faster down the path of genteel decline.