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IS THERE A FUTURE FOR THE EUROPEAN UNION – AND WITH BRITAIN IN IT?

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It is a privilege to be invited to deliver the Alcuin Lecture of 2013 on Britain and Europe, and I should like to thank in particular the Master of Clare College for hosting this event and Professor Christopher Hill for the invitation. I am deeply honoured, even more so having looked at the list of very distinguished speakers who have preceded me in the Alcuin Lectures sponsored by Lord Brittan.

I spent a good part of my academic life in this country and I am grateful for the things I learned and the opportunities I was given. I was elected to a Fellowship in European Studies – I have to admit it was in 'The Other Place' – only a few years after Britain joined the European Community, as it was then known, and some years before my own country also joined. I have devoted most of my working life to the study of Europe, and European integration in particular, often crossing rather timidly, the boundary between academia and policy. These are my qualifications for today's event, modest though they may be.

In the 2011 Annual Review Lecture of the Journal of Common Market Studies, I said that European integration had been for a long time like a car moving uphill. The French usually provided the driver, the Commission the map, the Germans paid for the petrol and the British oiled the brakes. And in the second half of the previous decade, it began to look like a car without a driver, the map being replaced by a GPS that went on and off, while the Poles insisted on taking an insurance policy with God, nobody wanted to pay for the petrol, some clearly cheated, and those inside disagreed loudly on how many more could fit into the car.

The road has become much rougher and dangerous in recent years. Many people believe we now have a driver and she is German, although there are still doubts about whether she, or anybody else, has the skills required for driving in such adverse conditions or whether anybody inside the car has a clear sense of direction. Meanwhile, the British have begun to wonder whether the time has come for them to get out.

Let me try to be more specific. The European Union entered the 21st century with three big projects that were meant to transform radically the political and economic scene in Europe: first, economic and monetary union, which is the most important act of integration since the very beginning; second, the biggest ever enlargement of the EU following the disintegration of the Soviet empire; and third, the turning of European founding treaties into a constitution.

It was meant to be yet another round of deepening and widening, as the European jargon goes, but on a much bigger scale than ever before. European integration was accelerating fast and it looked indeed like an unstoppable process. Britain did not feel comfortable with high speed. It did, however, decide it had no better choice than stay in the car waiting for the opportunity to put its foot on the brakes. As a last resort, it might try purchase a special ticket: an opt-out in official parlance.

The period of Euro-enthusiasm was, however, short-lived. And we have learned some hard lessons as Euro-enthusiasm went through a succession of reality checks. The first came with the so-called constitutional treaty. The referendum results showed that European citizens were no longer ready to give their leaders a carte blanche on the future of European integration. A yawning gap had opened between elected politicians and their electors on things European: parliamentary ratifications were mostly comfortable, voted by large majorities, while referendum results revealed much unhappiness and also large amounts of ignorance on behalf of citizens.

Referendums were a good occasion for citizens to express their unhappiness for all kinds of things, not always related to European integration. It was particularly so since the choice facing citizens was far from clear. Voting against the constitutional treaty was after all a vote for the status quo. Were people happy with that? Yet, the so-called permissive consensus on which European integration had relied for so many years seemed to be no longer there. Cracks had appeared on the surface and deeper down as decisions taken in Brussels began to reach the nooks and crannies of our societies in the context of a rapidly changing global economic environment.

The elitist conspiracy of European integration, full of good intentions and with remarkable results until then had probably reached its limits. The old question of more or less Europe was getting out of date. The relevant question now was about the kind of Europe we wanted to build, but we had no political mechanism as yet to address it. Instead of a constitution, we therefore ended up with the Lisbon treaty, as unreadable a document as the ones that had preceded it – and with hardly anything to add in terms of the much needed legitimacy for European institutions.

We have also learned that although the addition of new members has been indeed the most successful foreign policy of the EU, it has come with a price in terms of internal cohesion. Britain has consistently argued otherwise and, I believe, wrongly. Numbers also make a big difference. European councils of different denominations with ten or even fifteen members still behaved like a group. With 28 now, European councils are more like a mini UN conference. The behaviour of participants has changed as a result: the old chemistry is gone and the bigger countries are ever more tempted to strike deals informally. One of the main consequences is more intergovernmentalism all around.

Another lesson learned the hard way is that the so-called process of Europeanization, about which thousands of pages have been written, has its limits. In many cases, they are uncomfortably narrow. The EU exports rules, it provides benchmarks, it also offers money to the less developed countries and regions, but still there is so much that a weak centre can do to influence, not to mention control, what happens in different parts of this democratic empire. In other words, the EU surely makes a difference, but it is not and cannot be a modern incarnation of Saint Panteleimon (or Saint Pantaleon in the Western vernacular), the all-merciful heeler of all kinds of disease – and of institutional failure, I should add.

The crisis of the euro followed, and it has proved to be the mother of all crises. Economic and monetary union had been all along an exercise in high politics. It had much more to do with German unification and the new European political order after 1989 and less with any economic arguments about the existence or not of an optimum currency area in Europe. The agreement reached at Maastricht in 1992 was the product of economic orthodoxy prevailing at the time and political feasibility. It was meant to be construction in progress, from which Britain (I suppose wisely judging from the way things have developed) opted to stay out.

Early on, I had argued that economic and monetary union as designed at Maastricht was like a post-modern construction trying to defy the laws of gravity. It stood upright for almost a decade, and most participants were lulled into believing it would stay like that forever. But the forces of gravity finally caught up with us.

True, the origin of the crisis was international, not European. It was the bursting of the biggest financial bubble in the Western world since 1929, which finally exposed the basic contradiction of the euro, namely that of a currency without a state, as Tommaso Padoa-Schioppa, one of the leading European thinkers and policy makers, had so aptly put it some time ago. The bursting of the bubble also exposed a collection of different national failures within the Eurozone and beyond, arguably the biggest one being in my own country Greece.

The crisis of the euro has three main components. The banking and sovereign debt crises are closely interconnected although not specific to the Eurozone since other countries such as the US, Japan and also Britain faced similar problems. There is also an internal competitiveness component in the Eurozone crisis which can no longer be dealt with by resorting to exchange rate realignments for the very simple reason that there are no national currencies to devalue or revalue.

Many erstwhile 'unthinkables' have happened during the last three and a half years in an attempt to deal with the crisis. They include sovereign 'bail-outs' that dare not speak their name because they were supposed to be banned; a so-called voluntary haircut of Greek sovereign debt that may not be the last one in Greece or elsewhere; ferocious fiscal adjustment programmes in the embattled periphery of Europe which, combined with monetary squeeze because of capital flight, are causing economic and political implosion; massive interventions by the European Central Bank and direct purchases of government bonds in secondary markets.

And there is more: new coordination procedures for national economic policies and strict European policing of national budgets that will take shared sovereignty into new uncharted territory; and the setting up of a European financial mechanism with a dowry that is a multiple of annual EU budgets. Remember, by the way, that such a financial mechanism was not supposed to be there either because of the fear of moral hazard.

Now, the Eurozone countries are engaged in a long and difficult negotiation over the creation of a European banking union which should be the next most important step towards closer integration after the creation of the euro.

It is a long and impressive list of 'unthinkables' that have actually happened. But we are still nowhere near the end of the crisis. So, what is the problem? The answer is that European economies, those in the Eurozone in particular, have gone through the longest and deepest recession since the Second World War, some of them have been sinking and with no immediate prospect of a healthy recovery, unemployment remains very high especially among the young, many European banks are undercapitalized and thus unable to provide the liquidity necessary for economic recovery, and there is still too much debt hanging like an albatross from the neck of households, companies, banks and states in Europe. Worst of all perhaps, there is much unhappiness all around, both in creditor and debtor countries, social tension is rising in several places, anti-systemic and xenophobic forces as well. That is the problem in a nutshell.

The crisis has transformed regional integration into a negative sum game in the eyes of many of Europe's citizens. This is now being reflected in opinion polls where support for the EU has reached low levels that had never been seen before. While citizens in creditor countries of the North resent being asked to pay more money into what they suspect to be a bottomless pit, those in the beleaguered South see Europe as the policeman of austerity and responsible for economic and social hardship of an unprecedented scale. As for the rest, namely those outside the Eurozone including Britain, they feel being dragged along by decisions and policies adopted by the Eurozone countries, or simply becoming marginalized in a European Union where the euro determines the core group.

The European decision making system does not lend itself to quick decisions, and when decisions are finally taken, they are unavoidably the product of complex compromises, hence also the European tendency to muddle through. Furthermore, implementation often leaves much to be desired, while the usual cacophony of the European orchestra tends to upset financial markets – and we know that those markets are not particularly stable, psychologically or otherwise.

Economic divergence has grown inside Europe as a result of the crisis. The German experience is very different from that of Ireland, and the Irish different from that of Portugal or Greece. The combination of growing economic divergence and rising populism in individual countries has made common European decisions more difficult than ever before; even more so, since the costs involved in dealing with the euro crisis are very high indeed.

The crucial question, however, is about who pays the bill. We can discuss at length different perceptions and economic strategies to deal with the crisis: they do exist and they are indeed entirely legitimate. However, the most sensitive issue by far is how to distribute the burden of adjustment to a post-crisis world within and between countries.

This is a crisis that criss-crosses national borders much more so within the Eurozone because of the common currency and the high degree of financial interdependence. Agreeing on the distribution of the cost of adjustment, including the cost of dealing with the huge debt overhang, both private and public, left over after the bursting of the bubble, is not an easy matter at all. Not surprisingly, the half-baked political system of the EU, the Eurozone in particular, experiences great difficulty in delivering such an agreement.

Some doubt whether the currency union in its present form can make any economic sense: it is very heterogeneous, they remind us, there are misfits and the cost of keeping it together looks prohibitively high. This is not, however, the view adopted at present by most of those who count in Europe and who are apparently not prepared to take the risk of a breakup. They talk of the risk of contagion and they fear that a breakup would be disastrous in economic terms and could bring Europe back several decades unleashing nasty forces of nationalism in the process.

If so, we need a game changer, and this can only start in the economy. Without growth and the creation of new jobs, especially for young people, the political and social situation will remain extremely precarious in several parts of Europe. Austerity and reform has so far been the answer given by the creditors.

No doubt, fiscal consolidation is required in many European countries and further afield. Ageing populations, rapidly rising health costs, unsustainable pension systems and the large increase in sovereign debt resulting from bank rescue operations at the expense of taxpayers do not leave much of a choice in the medium- and long-term. To be honest, the problem in some countries goes deep and it certainly predates the bursting of the big bubble. I can think of one or two in the part of Europe where I come from.

There are indeed individual national failures, but there is also a systemic failure of European monetary union. A similar comment can be made about the economic strategy followed so far. What may be good for one country is not necessarily good for all of them at the same time. If several countries resort to fiscal contraction simultaneously while the private sector is also trying to reduce its debt exposure, the probability of ending up in a vicious circle of fiscal contraction and recession is very high, as Keynes explained long time ago. This is precisely what has happened during the last three years or so, with very tight monetary conditions in debtor countries contributing further to the recession.

Too much austerity may therefore kill the patient and turn the target of budget deficit reduction measured as a percentage of GDP almost into a self-defeating exercise. Output lost today cannot easily be regained tomorrow. The unemployed become long-term unemployed, while some of the best brains and the most mobile in the labour force leave countries with high unemployment – and some may never return. In such conditions, structural reforms become more difficult to accept by society, especially in countries with weak welfare systems and hence unable to even partially compensate the increasing number of those badly affected by the crisis.

Everybody talks about the need for reform in a rapidly changing global economic environment. And reforms are indeed necessary, although there are good and bad reforms. Some of those advocated by the European Commission and international organizations, especially as regards labour market liberalization, will have important distributional consequences within our countries. Is greater income inequality within the price to pay for becoming fit for European monetary union and globalization? The dilemma will be much more acute for countries that are now being forced to scale down their welfare systems.

Europe and the Eurozone in particular need a different mix of structural reform, fiscal adjustment and growth policies, with more emphasis today on measures to promote growth. A more symmetrical distribution of the burden of adjustment between surplus and deficit countries should be part of it.

The setting up of a banking union, comprising a common supervision and resolution regime as well a joint guarantee on deposits, should help to break the deadly loop between banking and sovereign debt crises. It is now the most important item on the agenda. But given the importance of banks in the economy, the often incestuous relationship between banks and political systems, and also the large amounts of money at stake, the ongoing negotiations on the creation of a European banking union are nothing short of a revolutionary development.

European banks need to be recapitalized urgently. Furthermore, as long as the mutualisation of public debt is out of the agenda, even a partial one, different forms of restructuring may prove necessary in order to deal with a public debt overhang which, in some cases at least, is unsustainable.

It is a tall order, no doubt. But is it politically feasible? The answer is yes perhaps, not because there is unrestrained appetite all around for further integration (and surely there is not), but simply because the alternative, meaning disintegration, is generally perceived to be extremely costly in economic and political terms.

Euro-agnostics and sceptics have in the past repeatedly underestimated the commitment to regional integration by so many of Europe's political leaders. Sure, this time the crisis is bigger than ever before. But my guess is that unless things get out of control, which cannot be altogether excluded, political leaders in the Eurozone will continue trying to do the absolutely necessary and not more, usually at the last minute, in order to keep the Eurozone intact and the European project on the road. The stakes are very high indeed.

Muddling through may continue to be the underlying motto, interrupted every now and then by decisions that constitute game changers. The creation of the euro was one, and the creation of a banking union will be most probably another.

Exiting the crisis will require more integration in some key policy areas, although certainly not everywhere. Yet, the awkward political question cannot be avoided. Are European societies ready to accept more shared sovereignty? And as a follow-up question: Are they ready to make the transition from European policy to European politics?

We may be forced by events to seek answers to those questions sooner rather than later. And I believe that the majority of citizens in many of our countries would be ready to answer yes to both questions depending of course on how this is done and by whom. I must warn you, however, that it is now the convinced European in me who speaks, not necessarily the sober and detached observer.

The crisis has changed the balance of power inside the Eurozone and the EU as whole. Germany has emerged, beyond any doubt, as the indispensable country and the lender of last resort. This has to do mainly with size and economic strength, but also with the structural advantage that Germany enjoys inside a European fixed exchange rate system.

It was not planned to be so. Germany was not at all eager to join a European monetary union: the majority of its citizens were against when the Maastricht treaty was being negotiated, while its politicians decided to go ahead regardless considering monetary union as a concession to France and the other countries in exchange for their support for German unification. Yet, the earlier history of European monetary integration could have taught us some lessons. All previous attempts had ended up as smaller scale, German-led projects. This was true of the so-called snake in the tunnel in the 1970s and it was also true of the European Monetary System that followed it.

Leadership has thus been thrust upon Germany as a result of the crisis. For a while at least, its political leaders gave the impression that they had no appetite for it or any clear idea about what to do with it. It has been a slow and painful process of adjustment for everybody concerned. Surely, it was not easy for German political leaders to sell expensive bail-outs of other countries to their increasingly unhappy citizens, although a clearer explanation of the benefits for Germany from regional integration and the euro in particular would have helped a great deal; it was rarely done. Critics also point to economic dogmatism and the lack of strategic vision in the way Germany has handled the crisis until now.

Many Germans, and many other Europeans, feel uncomfortable with the prospect of German leadership turning into some kind of hegemony, peaceful though it may be. During the six and more decades of European integration, surely some countries were more equal than others, but no single country dominated the scene for long. The project of integration was meant precisely to prevent such an outcome. The strengthening of common institutions in the future will therefore be crucial, and so will be restoring some balance between Germany and France. Such balance has often allowed other European countries enough space to defend their interests. Of course, Britain could have a key role to play in this respect, if only it chooses to do so.

Judging from current policies and the mood prevailing in this country, this is unlikely to happen – and it is most unfortunate. While the Eurozone has been pushed by events, mostly against the wish of its unhappy participants, towards closer integration, Britain has been pulled in the opposite direction by growing Euroscepticism at home manifested mostly within the ranks of the Conservative Party and the rise of the UK Independence Party (UKIP).

Assuming that the Eurozone survives and indeed grows further (Latvia will become the 18th member in January), it is bound to develop as the core of the European system. Today, this looks like the most plausible scenario. We knew all along that the decision of some EU countries to stay out of the euro, provisionally or otherwise, would create a two-tier structure inside the Union given the importance of the common currency. By almost monopolizing interest and attention, the crisis of the Eurozone has further strengthened this process. It is unlikely to change anytime soon.

The crisis has forced members to engage in new and daring acts of legal acrobatics. It is getting messier. As Eurozone members integrate further and seek more institutional autonomy in order to be able to manage a much higher level of interdependence, the distance from non-members is bound to grow. It is, however, difficult to predict what will be the implications for other EU activity, such as the internal market, for those countries that choose to stay outside the eurozone. Assuming, of course, there is no meltdown or any other big accident on the way, which would certainly not be in Britain's interest.

Other non-euro members are naturally concerned and they are making efforts to bridge the gap. Admittedly, this will not be an easy exercise. Others prepare, not in haste, to adopt the euro. But Britain has decided otherwise.

As you know, the Prime Minister has excluded the possibility of Britain ever joining the euro. He has also announced that, if elected in 2015, a new Conservative government will hold an in-or-out referendum in 2017 on the basis of a new settlement to be negotiated with Britain's EU partners with the aim of repatriating powers from Brussels. He will seek a mandate at the next general election for this purpose. And in order to prepare for it, a comprehensive review of Britain's EU membership is ongoing, including the so-called balance of competences between Brussels and London. Meanwhile, several MPs are trying to bring forward the date of the referendum.

There are so many unknowns on the way to 2017, including developments in the Eurozone and the EU in the context of an unstable global environment, the outcome of the next general election in Britain, and the outcome of the promised renegotiation of Britain's membership assuming we ever reach that far. A new big factor of uncertainty has therefore been added – and it is surely not a good thing.

Britain's membership of the EU, now 40 years old, has always been a business affair, an arranged marriage if you prefer, not an affair of the heart. There are many reasons for that, and I am sure some of you at least will understand them much better that I do.

Churchill's phrase in the famous Zurich speech of 1946: 'We are with Europe but not of it. We are linked but not comprised' apparently still holds true in the mind of many people of this country. Public opinion surveys show a significant decline of support for EU membership and European integration among British people. Those in favour are more likely to be found among the young, the educated and those on the left of the political spectrum.

Once the promise of a referendum has been officially made, it would be perhaps unwise for any political party to oppose it or simply try to avoid it. As long as the question of Britain's EU membership keeps hanging in the air, it will continue poisoning domestic politics while also tying Britain's hands in relation to its European partners.

The referendum may be indeed desirable, not just unavoidable, not as a concession to Eurosceptics and Europhobes but more so as an opportunity and a challenge for all those who believe that Britain is an essential part of Europe and want it to play a key role in the shaping of Europe's common future, without necessarily sharing the vision of the Illuminati. The British are supposed to be pragmatic, not visionary. We need both in Europe.

There is surely the risk of demagogues trying to hijack the referendum. It has happened in other countries before, although with this referendum the risk should not be that high. The reason is that the choice facing citizens will be quite clear: in or out of the EU.

The referendum will force a proper debate with facts and arguments, thus going beyond a mere exchange of prejudices and stereotypes. And this will be good for democracy.

It would help a great deal if the rest of Europe decides to make the best use of flexibility allowed by the treaties in order to accommodate British sensitivities and idiosyncrasies. The aim should be to keep Britain inside the common European home even if it chooses to abstain from some of the common activities.

If the need to deal with the euro crisis leads to a further revision of the treaties, this task would be made much easier in the context of an increasingly differentiated European Union, which is precisely the direction we are moving today. Whether Europe's political leaders have the stomach to go through the whole process of treaty revision once again remains to be seen.

It would not help, however, if the British government gives the impression that it is only interested in an à la carte approach to EU membership – or that it is not much interested in general in what happens in the world of Brussels.

This has been unfortunately the impression often given in recent years. In the words of Herman Van Rompuy, the President of the European Council: 'How do you convince a room full of people, when you keep your hand on the door handle? How to encourage a friend to change, if your eyes are searching for your coat'?

In a proper debate about the kind of relationship that the British people would choose to have with the rest of Europe, some important questions and issues will need to be further clarified.

One has to do with the conditions of free access to the large European market. Common rules and regulations are necessary for the proper functioning of a common market – we now call it internal market in Europe – consisting of mixed economies. They ensure access but also provide a level playing field between different national economic systems.

Sure there have been excesses due to the zeal often exhibited by Brussels bureaucrats, although more frequently through pressure from national governments, including the British. But to pretend that you can have free trade without a complex armoury of rules and regulations negotiated with fellow Europeans (foreigners, if you prefer) is to deny the reality of modern economies.

Another has to do with the City of London as an international financial centre and also a financial centre for the euro. If Britain stays out of the euro, which may be the right thing to do, and tomorrow also decides to leave the EU as well, how exactly do people see the role of the City as an offshore financial centre in an increasingly regulated international and European environment? I personally do not see it.

In a multipolar world in which the centre of gravity is gradually shifting from West to East, while size continues to matter a great deal, Europe as a bloc may have some chance of defending its collective interests. Individual European countries are unlikely to count for very much. How will it be different for Britain? And how will she be able to preserve the special relationship with the US? The latter has sent repeatedly a warning message and in no uncertain terms.

Some people contend that Britain is condemned to be in a minority within the EU. But experience suggests otherwise, whenever Britain decided to play European ball and when it tried with some consistency to win friends and allies. True, the euro is acting as a catalyst for the creation of a two-tier structure but the Eurozone is not a homogeneous group of countries that are always bound to act as a bloc. Sweden and other countries have already learned that much.

I am sure there will be full and enlightening answers to those questions and many more in a proper debate on Britain's relation with Europe, a debate that is still to take place. Britain's friends in Europe – and they are many – are looking forward to it.