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Eventual Eurozone Reform and improving Russian/European relations

The EU is wisely, four months on since the UK referendum vote to leave the EU, less inclined to dismiss Brexit as an event of little significance, a matter just for the British. The EU is more likely now, in the wake of Brexit, to start to face long overdue reform. Changes needed in the Eurozone, with luck, could be under discussion by December 2019 but it again may well be postponed. Defining a core Eurozone involving a Fiscal Union and a Banking Union will have to be openly discussed, as already has been done informally by Germany and the Netherlands. Initially at least with Belgium and Austria. Even if something dire happens to the Eurozone these four countries will ensure that a small Eurozone continues. The question is who will be their partners? As for France a lot will depend on the outcome of the French elections. But for the first time, whereas it would have been automatic in the past that Germany would insist on French membership, there may not be the level of public support after the elections in Germany to include France initially.

It is very unlikely that German public opinion will accept any system of automatic money transfers to Italy even if Schauble and Merkel succeed in trying to get the ECB to stop quantitative easing by their autumn 2017 election and there is some fiscal deflation in Italy and other Eurozone countries. Other countries that would want to be part of a core Eurozone are Spain and Ireland. Finland in the past would have expected to be a member; perhaps not now. Luxembourg will want to participate but they, Ireland, Cyprus and Malta, may need to face tax haven questions first as it is very undesirable that any unacceptable practices should be inherited by a new Fiscal and Banking Union. Other small Eurozone countries might technically manage the disciplines but I have not attempted to identify them and the decisions are anyhow for the core Eurozone countries to take.

The core Eurozone countries cannot throw a number of countries out of the Eurozone given the practical politics of the EU. What they can do is make them ineligible to be part of a core because of the way that core has fixed the initial criteria for a Fiscal and Banking Union. The weakest economies would become more vulnerable to speculative moves aimed at destabilising some of their economies but if they can ride out speculation they might be able to stay in the Eurozone even though they were not protected as would be members of the core. Aware of their vulnerability and anticipating such speculation, some might prefer to leave rather than await being forced to decide to leave at a time of crisis. The best outcome would be if Italy voluntarily chose to leave the Eurozone for they would have the power to lead a serious

restructuring of the EEA and ensure it was not unduly influenced by core Eurozone members. And others like Greece and Portugal might follow.

A core Eurozone will not be a North-South Eurozone in the sense of a formal geographical divide, though this may be the appearance. A divide will happen because of the design and disciplines of the core. Some countries that stay in the Eurozone and make the transition will be able to qualify to be part of the Fiscal Union and Banking Union over time. In effect this core will become a federal Europe.

The key to a core Eurozone emerging will be their use of Article 136 (1) of the Treaty on the Functioning of the EU (TFEU) which states “In order to ensure the proper functioning of economic and monetary union ...the Council shalladopt measures specific to those Members whose currency is the euro. Article 136 (2) provides that “only members of the Council representing Member States whose currency is the euro shall take part in the vote.” So all they need is a majority within the Eurozone.

As Jean-Claude Piris argues in his book, “the scope of application of Article 136 is extremely wide, because many measures may be characterised as ‘strengthening the coordination and surveillance’ of the budgetary discipline of the states whose currency is the euro, or as ‘setting out economic policy guidelines for them’.”¹ What the core introduce will legally be EU measures and the new criteria will apply to new applicants to the Eurozone. There could and should be added on transitional arrangements for helping existing Members introduce greater discipline. But inherent in this design is that some existing Eurozone countries will never be able to accept core disciplines.

The as yet unanswered question is whether the German people will give the green light or a red light to their politicians in the autumn of 2017 to save the Eurozone by developing a core Eurozone as a Fiscal Union, where financial resources move through independent decision making from the core Eurozone’s richer regions to poorer regions. It would require the members to appoint an economic head of the core Eurozone to work with the ECB. The reluctance of the French people to accept even European Commission disciplines within the present framework also needs to be faced up to in France. Juppe, of the likely French Presidents, would have the least difficulty in accepting financial discipline. But Marine Le Pen after campaigning to leave the Eurozone as part of her Presidential bid may have considerably changed the nature of the debate in France on the Eurozone.

The Eurozone crisis, oft predicted, most recently by Joseph Stiglitz², the Nobel Prize winner, a believer in a North-South split of the Eurozone, hovers ominously in the background. Stiglitz judges the 17-year-old monetary experiment “an economic and political disaster”. “Flawed at birth,” he argues, the “structure of the euro is to blame for

¹ Jean-Claude Piris *The Future of Europe: Towards a Two-Speed EU?* (Cambridge University Press, 2012), p. 107

² Joseph Stiglitz, *The Euro And Its Threat to the Future of Europe* (Allen Lane, August 2016).

the poor performance of Europe, its successive crises and increased inequality.” Far from promoting European prosperity, peace or influence, it has “tied together” countries with vastly different economic and social backgrounds, denying them the vital ability to manipulate their exchange and interest rates.

In France much will depend on whether Sarkozy or Juppe reach the second run off election widely expected to be with Marine Le Pen. Juppe looks more likely to have the same ability to draw votes from the left in France as the Gaullist, Jacques Chirac, did in the run off against Marine Le Pen’s father. But prediction based on past precedent may be misleading.

What about reform of the European Central Bank (ECB)? It is important to recognize that it is not a normal central bank because it is the central bank of a half-baked currency union. Were the ECB a normal central bank, when Greece was facing a run on its banks it would have lent, and if it thought Greek banks insolvent it would have had to recapitalise them and fund them through a properly constructed European stability mechanism. The fact that it has been inhibited from doing so at every turn in the Greek crisis is a reflection of the flawed nature of the legislation covering European Monetary Union (EMU).

Improving Russian/European Relations

Besides Eurozone reform, there is the need to face up to President Obama’s criticism that Europe is “freeloading” within NATO and the disappointing record of the European External Action Service, EEAS. This embryonic department of foreign affairs for a federal Europe was responsible for the EU/Ukraine Agreement which did so much to ignite the conflict within Ukraine challenging the diplomatic skills and the security of a wider Europe. This conflict could very easily have spilled over to engulf Europe in a war.

The danger is less now but it has not disappeared. When Putin returned as President of the Russian Federation in May 2012, after his initial two terms following the one term presidency of Medvedev. It should have been obvious that he was poised to make his presence felt across the wider Europe in the light of the policies he had developed during the five-day Georgian war of August 2008. Russian armed forces after Georgia had already been set on a path of reform and re-equipment. Putin had clearly vowed that never again was he going to be treated with a superficial friendliness by a US President like George W. Bush, but ignored on substance, something which in a different way continued under President Obama. Putin’s KGB training demands a serious and structured relationship, not necessarily adversarial but that is what has developed. Recreating the warmth associated with Gorbachev and Yeltsin will be difficult, but slowly not impossible.

It is too easy to forget that Putin had made an unprecedented offer of friendship to the United States immediately after 9/11, reinforcing this offer with concrete measures,

with the unilateral announcement of the closure of bases in Cuba and North Korea but it was ignored, leaving him sore and humiliated. Putin is now suggesting that he might return to bases in both these countries as well. The port facilities Russia has had on the Mediterranean, since 1971 in Syria, was never going to be surrendered to control by forces fighting Assad. It was to protect Damascus Putin enhanced capability by building up airfields Russia had access to in Syria. Putin, as acting President after Yeltsin stood down, decided to deal with the Islamic Sunni jihad in Chechnya. The brutal destruction of Grozny was in his terms a success. Hence now Aleppo. He believes only brutal bombing achieves results with minimal casualties to his own military. Yet he will continue to bomb ISIS because they want a Sunni caliphate which is a threat to Russia. He has cooperated with Shia forces from Hezbollah and Iran in Syria while talking to Israel and Arab countries. The policy on his terms has succeeded and if Iran has a continuous land route to the Mediterranean he still believes he can be a player in brokering a peace of sorts between Israel and the Palestinians.

Putin's Kremlin watched with apprehension NATO and then the EU coming right up to the borders of the Russian Federation. From May 2004 Poland, Hungary, the Czech Republic, Slovakia and Slovenia, the last mentioned formerly part of Tito's Yugoslavia, had come into the EU, as had the three Baltic states, Estonia, Latvia and Lithuania. Russia is not like the USSR, it now has a market economy that is not likely to disappear. But there is less and less enthusiasm in the US for working constructively with Russia on economic questions. This is not another Cold War but it has been called a 'Hot Peace'.

The EU needs to accept that the EU/Ukraine Association Agreement in 2014 was a trigger for the Russians' military involvement in East Ukraine and the Crimea. They chose to regard it not without reason as a substitution of an EU defence policy for Ukraine where NATO was declining to go. The more that agreement is examined in detail the more concern it will generate in EU countries. That Agreement was voted down in 2016 in a low poll referendum in the Netherlands. The Dutch daily *De Volkskrant* on 22 October reported that Mark Rutte, Prime Minister of the Netherlands, is upholding his threat to refuse to ratify the EU-Ukraine Treaty, in accordance with the referendum result and is seeking an opt-out on military cooperation with Ukraine and a guarantee against allowing Ukrainian EU membership and free movement of people.

Russia needs to recognize that the annexation of Crimea and boundary change for the Russian Federation cannot be accepted other than within a negotiated regional settlement and having some regard to the Budapest Memorandum which was signed by the UK, with the US and Russia, in 1994. The signatories to that agreement reaffirmed 'their obligation to refrain from the threat or use of force against the territorial integrity or political independence of Ukraine'. Even as recently as 4 December 2009 the US and Russia confirmed these assurances and recorded them at a meeting.

The EU/Russian relationship is deteriorating as economic sanctions have been renewed again and some on both sides of the Atlantic want sanctions toughened. Renzi, however,

the young Italian Prime Minister resists, a vestige of Berlusconi's warm relationship with Putin but a position also rooted in post-war Euro Communism. Before the US, Germany and France go down this route of harsher economic sanctions we need all of us to learn from past mistakes and start a negotiation which should take as its starting point the Budapest Memorandum. Hopefully the Permanent Five on the Security Council plus Germany could agree terms of reference for such a negotiation.

The memorandum issued from Budapest was designed to reassure Ukrainian public opinion. The signatories, UK, US and Russia, France signed separately, to that agreement reaffirmed 'their obligation to refrain from the threat or use of force against the territorial integrity or political independence of Ukraine'. Even as recently as 4 December 2009 the US and Russia confirmed these assurances and recorded them at a meeting. Ukrainian public opinion was challenging the decision that 4,000 strategic and tactical nuclear weapons should be transferred from the Ukraine to Russia, in addition to 1,900 strategic nuclear warheads – a larger arsenal than Britain, France and China combined. Also included were 130 SS-19 ICBMs, 46 SS-24 ICBMs and 44 strategic bombers with hundreds of air-launched cruise missiles.⁵ The annexation of Crimea by Russia in 2014 may be cited not just by Ukrainians, but elsewhere in the world, for decades to come as the vindication for those who believe 'if you have nuclear weapons never give them up and if you have not got nuclear weapons find a way of getting some'. That doctrine, if it takes root, has profound dangers to the whole Non Proliferation Treaty.

Negotiating Objectives for P5 +1

- (a) There should be no formal recognition of Crimea being part of the Russian Federation, implicit or explicit, unless and until a negotiated resolution is achieved, in the context of Ukraine and Transnistria with a settlement in Eastern Ukraine.
- (b) There should be no further extension of NATO to cover the territory of Ukraine or Georgia or extension of the EU defence and security provision to either of these two countries though that does not exclude their membership of EU. A further attempt would be made to agree the boundaries of Georgia.
- (c) The Budapest Memorandum shall be reaffirmed by the Heads of State of the original signatory countries.
- (d) With the coming into force of (a), (b) and (c), economic sanctions against the Russian Federation should cease.

There can be no guarantee this regional negotiation covering all disputed boundaries can even start, let alone succeed. But a starting point would be the prescient wisdom of the American diplomat, George Kennan, about Russia and NATO which was said in an interview with Thomas L. Friedman of the New York Times on 2 May 1998 when Kennan denounced the form of NATO expansion that had just been agreed by the US Senate:

“I think it is the beginning of a new Cold War. I think the Russians will gradually react quite adversely and it will affect their policies. I think it is a tragic mistake. There was no reason for this whatsoever. No one was threatening anybody else. This expansion would make the Founding Fathers of this country turn over in their graves. We have signed up to protect a whole series of countries, even though we have neither the resources nor the intention to do so in any serious way. [NATO expansion] was simply a lighthearted action by a Senate that has no real interest in foreign affairs.”

Meanwhile a new EU defence posture formally held back until after the UK referendum was launched in the summer of 2016 and a EU military HQ heralded in the German defence paper³ will be added against British advice. I see no point in the UK threatening to block this undesirable development. It can, anyhow, be introduced through the enhanced cooperation mechanism with the EU Treaties. So it makes good sense for the UK to reinforce its NATO commitment as part of a staged exit from the EU sooner rather than later and to leave the European External Action Service, EEAS, by agreement in 2017. The UK should agree to dedicate that EEAS saving to NATO on top of the UK's pledged 2% of GDP contribution so that all of Europe will benefit and not just the UK.

Leaving the EEAS by agreement now is a far better option than blocking EU defence as the UK Secretary of State for Defence unwisely promised to do for the next few years until Article 50 negotiations are completed. Already quite sensibly the other 27 EU states met at Bratislava without the UK and that is planned to continue. Far better a fair and square deal in stages and taken over months rather than a shotgun arrangement on a cliff edge in two to three years time.

Only in a revived NATO, where European countries are no longer as President Obama rightly accused us of being ‘freeloaders’, and we make a greater financial contribution, will Europe redress the imbalance between us and President Putin's Russian Federation. The UK's priority outside the EU and the EEAS will now be to strengthen the Atlantic alliance. Over the next 4 years besides adding the present UK EEAS budget to our contribution to NATO we will need to move as quickly as we can to devoting 2.5% of GDP to NATO to be seen as serious. The UK should also continue to spend the £2 billion on Eastern Europe we do at present and in other ways help the political stabilisation of the wider Europe. In leaving the EU the UK should demonstrate its continued goodwill with a readiness to increase spending with some coming from the DFID budget. When the EU recognizes that the UK is even more committed to European stability as well as security then Brexit will be seen in a different light as strengthening the wider Europe.

END

³ White Paper on German Security Policy and the Future of the Bundeswehr, 13 July 2016.