What Greece Teaches us about Democracy[1]

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Abstract

This paper offers an alternative interpretation of the ongoing crisis in Europe, by explaining the following three related points. One, the issue is bigger than the euro, involving a broader aspect of European integration. Two, the question is bigger than Europe; it is about how to improve governance at national and supra-national levels. Three, in the end this is a Greek lesson in democracy, which teaches us the importance of asking people how much sovereignty they are ready to give up in order to have overall stability.

When democracy does not work well, voters vote for politicians who conduct expansionary monetary and fiscal policy to give them growth without painful reform. But without reform that allows funds to flow into investment that improves productivity, expansionary policies result in financial and real estate bubbles. Supra-national agreements can make reforms inevitable if not more palatable. But nations resist this in the name of sovereignty.

The EU's efforts at improving governance suggests the tidings of a fundamental change, not for what has been achieved already but for how difficult it has been to get even this far. The crisis is a lesson in democracy originating in Greece. Europe is revealing a fundamental problem in integration. Democratic nations will not participate in integration unless they retain at least some sovereignty, but integration will not work unless they cede some sovereignty. The problem is that the two sets of sovereignty sometimes overlap. This is a problem that all nations of the world will face in coming years, with increased interdependence. In this sense, Europe still leads the way.

I. An Alternative Interpretation of the European Crisis

In October of 2009, a new, Socialist government led by Prime Minister Papandreou came into power in Greece. Before long, the world was told that the ratio of Greece's government deficit to GDP was around 13%, much higher than the previous government had admitted.[2] The rest is an on-going history. After agreements on rescue packages and initiation of reform, some people are still talking about a possible break-up of the euro area. Many blame the euro for the crisis, arguing that the euro should not have been introduced in the first place, because the euro area was not an Optimum Currency Area.[3]

This paper offers an alternative interpretation of the crisis, by explaining the following three related points. One, the issue is bigger than the euro, involving a broader aspect of European integration. Two, the question is bigger than Europe; it is about how to improve governance at national and supra-national levels. Three, in the end this is a Greek lesson in democracy, which teaches us the importance of asking people how much sovereignty they are ready to give up in order to have overall stability.

II. Better off with than without the Euro

Before we discuss why the issue is bigger than the euro, we should first tackle the question of whether Europe should regret or even abandon the single currency. Clearly, the answer is a resounding ‘no’, given the high economic interdependence in Europe. We need only ask what would have happened/would happen if the euro did not exist.

Without the euro, many Member States would have had their exchange rates tied to the Deutche Mark (DM). The so-called Lehman shock would have caused tremendous havoc of the type Europeans are familiar with, or worse. The DM would have strengthened, and trade and capital flows between Germany and its partners would have been severely disrupted.

What about abandoning the euro now? Some say that the euro area is in huge trouble because they must tighten their fiscal policies while they are unable to boost the economy by using monetary policy. But monetary loosening is not on the cards, with or without the euro. All EU members have an incentive to keep their exchange rates stable against the DM. This means following the conservative central banker, the Bundesbank.

Should the Bundesbank have a less disciplined monetary policy, then? To answer this question, we should recall how the Bretton Woods system ended. The fixed exchange rate system under Bretton Woods was not a currency union, it was an arrangement similar to the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) which Europe had before the euro. The Bretton Woods fixed rate system ended because the country at the centre, the USA, did not conduct monetary policy with discipline. Likewise, the ERM of the EMS would have disintegrated had the Bundesbank abandoned its conservative monetary policy stance. Those who criticise Germany for its preference for austere monetary (and fiscal) policy would do well to remember this. True, some members have difficulty keeping up with German-style policy discipline. As we have seen recently, European currency markets face turmoil as a result, from the *periphery*. But if there were no monetary discipline at the centre, turmoil would originate from the *centre*. Monetary discipline is the only choice for members of a group of countries who want exchange rate stability, whether they are at the centre or periphery. If the country at the centre of an exchange rate system runs a monetary policy that is loose enough for the prodigal countries to be able to easily follow, the system will eventually break down.

As for fiscal discipline, that is a must if countries are not to put undue burden on posterity, and avoid downgrades or defaults. The low interest rates brought by the euro to PIIGS (Portugal, Ireland, Italy, Greece and Spain) caused them to spend beyond their means. It is not as if the public and private sectors of these countries would have had fiscal discipline had they not had the euro. So removing the euro is not going to help them. With the euro, one member's potential default becomes every member's business. But without the euro, a country can still face the risk of downgrades and defaults. Even without the euro, a default by a European country perturbs all European states.[4]

Undisciplined monetary or fiscal expansion is not an option, for Germany or for any other Member State. None of this will change by abandoning the euro. Of course too much policy discipline leads to recessions.[5] But this fact is independent of whether we have the euro.

Some argue that the euro area is doomed because in order for the euro to work, everyone has to 'become German' and that is terribly deflationary. If they 'become German', there will be budget discipline everywhere in the euro area but the economy will be too weak for some of the members to be solvent. If they do not 'become German', then some of the members again will not be solvent. Either way, the area will collapse. On a theoretical level, this is a viable argument. But the important thing is to look at the very same phenomenon with a different logic. The euro took away the easy way out. Governments are for the first time implementing reform, and the public, angry as they are, have essentially no choice but to accept it. Fortunately for the area, the weak euro is helping by providing higher demand from overseas, which should make the pain of reform more palatable.[6] So there is still the scenario of pulling through, with the right balance between fiscal retrenchment and reform on the one hand and increased economic activity bringing in more tax revenues on the other.

With or without a weaker currency, the road to economic recovery is reform. Monetary and fiscal austerity's desirability depends on whether we are pre- or post- crisis, and this applies to Japan as well. As many have already suggested, many European countries should have reduced their public deficits and debts in their booming years. In contrast, after a serious crisis, it is folly to reduce government spending and money supply too quickly. What is important and equally difficult is when to reverse expansionary policy. In the meantime, countries tend to rely on export expansion. In order to increase exports, the price of exports has to be competitive, in the sense that it convinces the buyers that its price meets its quality. If countries try to achieve this by the exchange rate only, the result is competitive devaluation, a fruitless and dangerous path. The other way to maintain competitiveness is through the price and quality of the exports. EU economies need to improve productivity so that high quality can be maintained at a reasonable price. This is why reform of the type encouraged by the Lisbon strategy and Europe 2020 are essential.

Aside from encouraging reform, there is something else important which the euro does. The euro forces members to think seriously about the amount of sovereignty that has to be given up in an increasingly interdependent world. In this way, Europe remains an example to the rest of the world. We return to this point in the final section of this paper.

III. The Issue is Bigger than the Euro

A country that joins a single currency area loses its monetary policy autonomy, but frees itself from the worry of exchange rate gyrations. The loss of monetary policy autonomy is on the other side of the coin of exchange rate stability. This is because the relationship between (1) exchange rate stability, (2) monetary policy autonomy and (3) free movement of capital is governed by what economists call the 'inconsistent triangle'. The triangle with these three policy goals at each node is 'inconsistent' because in general you cannot have all three at the same time. For instance, if there are no capital controls, then the exchange rate cannot be kept stable unless monetary policy autonomy is abandoned, in general.[7] Mundell's Optimum Currency Area theory is based on the same principle. If a country or region liberalises capital movements and then gives up the exchange rate as a freely moving adjustment variable, it gives up monetary policy as a tool to stabilise the domestic economy. If this is the case, we need additional adjustment variables, such as labour and capital.[8] The benefit that the country or region gets in return is of course exchange rate stability.

For euro area members there was the added benefit of lower interest rates, as the euro successfully inherited the credibility of the Deutsche Mark (Figure 1).

Once discipline is achieved and reflected in lower interest rates, that cannot be the end of the story. Discipline must continue. Only if the government does not spend beyond its means, wages and other production costs are kept under control, and funds are used productively both on the demand and supply sides, do lower interest rates pose no danger. If these conditions are not met, a bubble is likely to develop.

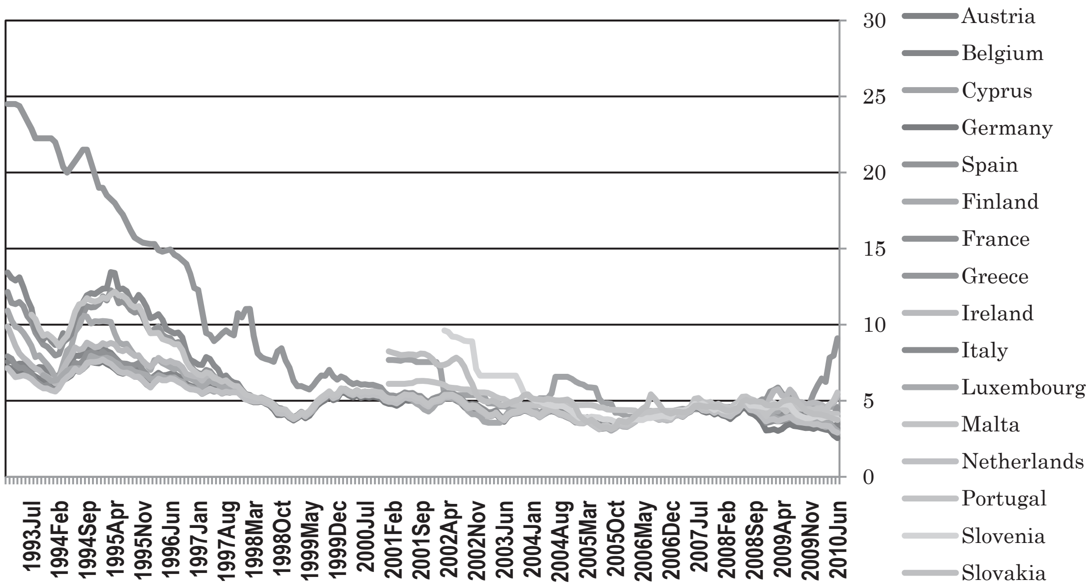
Unfortunately, the latter turned out to be the case in countries that have come to be known as PIIGS. Low interest rates led to higher leverage in both the public and private sectors. The money borrowed was not used productively. Productive uses of borrowed funds would have been, on the demand side, purchase of goods and services; on the supply side, investment to boost productivity. Unfortunately, the funds were poured mostly into real estate and new financial instruments. The result was real estate bubbles and balance sheets full of fancy financial products almost nobody understood. And governments missed the opportunity to cut unproductive spending or reform the tax system.

In other words, the low interest rates enjoyed by PIIGS did not reflect the true strength of their economies. Changes in real effective exchange rates show this (Figure 2). The real effective exchange rate represents the competitiveness of a country's products compared to those of its trading partners, in terms of both the exchange rate and price levels. For euro area members, the exchange rate does not change. So changes in the real effective exchange rate are due to relative changes in price levels. And prices reflect production costs. Evidently, Spain, Italy and Greece did a very poor job of controlling production costs compared to Germany.

Countries such as Greece are in trouble because they enjoyed the benefits of low interest rates without doing their homework. The homework was structural reform. True, the low interest rates were brought about by the euro. But members should have used the resulting improved economic climate as a chance to push through painful reforms. Instead, they squandered the opportunity given by the euro. The euro area crisis is due to insufficient reforms, not the euro itself.

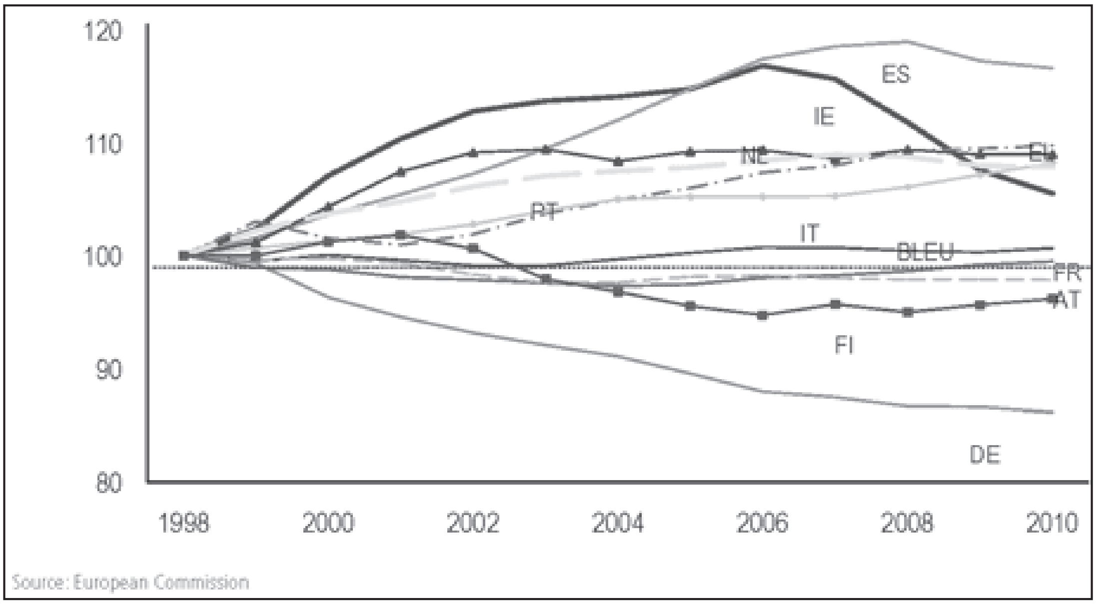
In fact, rather than a liability, loss of sovereignty over economic policy is a potential asset to many euro area members. That was one of the points about joining the euro. Members wanted to hire not just a conservative central banker but also a conservative fiscal authority, albeit indirectly through the required discipline. The latter did not happen, because the euro area has a unified monetary authority but independent fiscal authorities. The 'Stability and Growth Pact' was supposed to encourage fiscal discipline. But the Pact was not effectively implemented. Member states, including Germany and France, refused to give up sovereignty over fiscal policy. They continued to do so as long as they could get away with it. The current crisis is a message that they actually cannot do so forever. There comes a point where members of a currency union must do one of two things. Either they adopt the required discipline on their own or be forced to do so. The Stability and Growth Pact was supposed to encourage self-discipline, but didn't. Effective implementation of this kind of supra-national pact needed much better governance.

Figure 1. Long-term (10-year) Interest Rates (%)



Source: ECB http://sdw.ecb.europa.eu/home.do

Figure 2. Real Effective Exchange Rate Developments, based on GDP deflator (1998=100)



Source : http://ec.europa.eu/economy_finance/een/017/article_8897_en.htm
PT:Portugal, IT :Italy, IE:Ireland, EL :Greece, ES :Spain, NE:Netherlands, BLEU: Belgium and Luxembourg, FR: France, AT: Austria, FI: Finland, DE: Germany

IV. European Efforts to Improve Governance

The Europeans are now fully aware of this need. A task force headed by the European Council President Herman Van Rompuy was formed in May 2010. The Van Rompuy Task Force has four main tasks: (1) strengthening budgetary discipline through the Stability Pact, (2) reducing divergences in competitiveness between the Member States, (3) ensuring an effective financial crisis mechanism and (4) improving economic governance and coordination. In September 2010, President Van Rompuy presented final proposals to the meetings of the euro area finance ministers and the Council of EU finance ministers. On October 18th 2010, ministers gathered in Luxembourg to discuss the new rules for improving economic governance and safeguarding the euro. Here, a Franco-German deal was struck. French President Nicolas Sarkozy consented to the German proposal to renegotiate the EU treaties, in order to create a permanent EU mechanism to replace the European Financial Stability Facility.[9] In order to win France's support, German Chancellor Angela Merkel yielded on the issue of making the sanctions on the offenders of the Stability Pact 'near-automatic' (as proposed in September by the European Commission). President Van Rompuy is to submit proposals for 'a robust crisis resolution framework' by March 2011, and the treaty change must be agreed by 2013.

Reopening the treaties is an idea that even some Germans prefer not to entertain, as it requires the approval of all 27 EU Member States all over again. However, a permanent crisis resolution mechanism (including rules for debt restructuring and financial support) of the kind Germany has in mind cannot be established without such a move.

Chancellor Merkel's apparent climb-down on the automaticity of sanctions was not at all popular with some smaller Member States like Finland, which preferred the strict discipline approach. Not only that, President Jean-Claude Trichet of the ECB openly expressed his dissatisfaction by 'refusing to endorse the full package of eurozone sanctions decided by European Union finance ministers'.[10] The concern was justified. This particular Franco-German compromise signified that Finance Ministers retained the right to decide by a Qualified Majority Vote whether sanctions should be imposed. It was precisely this leniency that allowed both France and Germany to avoid being sanctioned in 2003, when their budget deficits violated the Stability and Growth Pact. This fact, along with former Commission President Romano Prodi's unfortunate remark that the Pact was 'stupid', has been used time and again in justifying some Members' relaxed attitude about the Pact. The EU would have been back where it started.

As it gradually became clear, sending the EU back where it started was not Germany's intention. At the summit held on November 28th and 29th, Ms Merkel suggested the suspension of voting rights of offending member states as a 'last resort'. Most in attendance, including President Jose Manuel Barroso of the European Commission, objected.[11] But Chancellor Merkel got what she asked for in terms of the renegotiation of the EU treaties.[12] As we discuss below, this could have profound consequences on the future of the EU.

Budgetary decisions are not the only aspect of the EU that needs stronger governance. The Van Rompuy Task Force's agenda included 'reducing divergences in competitiveness between the Member States' and 'improving economic governance and coordination'. Europe's Lisbon Strategy, introduced in 2000, was supposed to make Europe 'the most competitive and dynamic knowledge-based economy in the world' by 2010. The strategy called for reforms that would encourage innovation and worker participation. But the Lisbon Strategy used the 'open method of co-operation', whereby members were evaluated by one another to create peer pressure with surveillance by the European Commission. There were no penalties for failing to meet specific goals. The open method was adopted because members wished to respect each others' sovereignty over policies in areas such as employment and social protection. Because of this the Strategy failed to bring about results. Now Europe has a new strategy, 'Europe 2020', to make Europe 'a smart, sustainable and inclusive economy delivering high levels of employment, productivity and social cohesion'. The new strategy is likely to follow the same fate as the Lisbon Strategy, without serious improvement in 'economic governance and coordination'.[13]

In terms of avoiding another crisis originating in the financial sector, the EU now has new institutional arrangements. On 2_{nd} of September 2010, EU leaders agreed a new method of financial sector supervision. The proposal is to establish three new EU-level watchdogs for the banking, insurance and securities markets sectors in London, Frankfurt and Paris respectively. National authorities will retain the right to supervise national institutions. But the watch-dogs will write the common technical rules and standards, and in 'emergency situations' could acquire additional legally binding powers. Consultations on governance reform in Europe is said to have gained speed in reaction to the passage of the Dodd-Frank Financial Reform Bill in early July 2010, but of course speed is not everything. It remains to be seen how effective these institutions are.

With so much homework to do, it should be clear that the €750 billion rescue package agreed in May 2010 gave Europe only temporary reprieve. Moreover, other sources of turbulence remain. The weak euro is improving the economies, but the banking sector is not in good health and progress in structural reforms is insufficient. Some governments may yet default.[14] Undeniably, Europeans really do need to get serious. The unfortunate fact is that the better the economy, the smaller the incentive for painful reforms.

V. The End of the EU as We Have Known It?

The EU's efforts at improving governance suggests the tidings of a fundamental change, not for what has been achieved already but for how difficult it has been to get even this far. Many EU leaders understand that it is time to take the harder options. President Trichet is one notable example but others in Member States including Germany are expressing this understanding.

The simplest picture of the process of European integration is one of ‘visionaries leading the less visionary’.[15] We can say this without discrediting at all the voters who prefer, with reason, to concentrate more on everyday activities rather than grand visions. These voters accepted progress in European integration because it was in their interest. Throughout the process of integration, up until recently, most voters were getting richer and healthier, and they accepted the explanation that this was at least partly due to European integration. But ironically, this began to change in step with the increase in stability and prosperity. Labour and other markets became more and more rigid. Protection became strong enough to hinder job creation and innovation. Voters refused to accept the dismantling of legislations that allowed them to enjoy the status quo. In a way, there was too much democracy. Everybody had a right to demand protection, and demand the continuation of that protection. Along with longevity, this meant government deficits and debt increasingly acquired a structural nature.

Monetary and fiscal discipline? Democracy will not allow both. After the introduction of the euro, monetary discipline was imposed on every member, and fiscal expansion was the only way to keep the voters happy. And when markets bought the monetary discipline argument and allowed interest rates to converge towards low levels, leverage became another way voters satisfied themselves. After Lehmann, monetary discipline is put on hold. Now there is call for much more fiscal discipline. Countries like the UK are aggressively moving in that direction, but the fact remains that having *discipline on all fronts* is close to impossible under democracy.

Up until now, the EU somehow muddled through, by constantly striking a balance between too much democracy and too little democracy. The Lisbon Strategy was introduced, but there were no sanctions, only peer pressure under the Open Method of Co-operation. The euro was introduced, but the Stability Pact did not really bite. To begin with, the Maastricht Treaty’s convergence criteria were not entirely strictly interpreted.

But now, the era of having it both ways must come to a close. There has to be a stronger incentive than peer pressure for badly needed reforms to proceed. There has to be a politically incorruptible mechanism that triggers sanctions for fiscal profligacy. In other words, EU leaders must face up to the voters and have the courage to reform EU’s governance.

The change in the EU treaties envisaged by Germany, if adopted, could point to profound changes. The treaty change is expected to be minor, with the hope that this will enable some countries to ratify them without a referendum. But what is important is not the actual number of lines added, it is the way in which the EU will operate post-treaty change. At least at this stage, Germany seems to be moving the EU in the direction of hard choices, albeit painfully and slowly. If this happens indeed, the EU will be operated in a way that reveals more clearly who is in and who is out, who can follow and who cannot.[16]

This will be good for the survival of the EU, because the only way for the EU to survive is to not survive as it is. No more papering over the differences with platitudes like 'variable geometry'. The threat of an orderly default should be more credible. Orderly withdrawal from the euro area and even the EU should be more credible. Otherwise, EU citizens will continue to take the EU for granted. They will not vote for politicians who take the steps necessary for the EU and the euro to continue. The EU needs to change into a body where like-minded nations can move together, without worrying about whether excluding others is justified, to create and maintain a project. This is not a question of preference, it is a question of hard facts. It is dictated by economic and not political logic. It is not difficult to see that a union of 27 members is harder to have unified policies than a union of six or even fifteen. But what pushes the EU and euro area towards differentiation is not the increase in the number of members. It is simply that a monetary union without monetary and fiscal discipline cannot survive. And an economic union cannot prosper unless voters come to understand that prosperity comes with a cost.

VI. The Question is Bigger than Europe

Governance is not an exclusively European issue. Governance needs to be improved at the national level in many other countries of the world, as well as at the global, supra-national level.[17]

Japan is a prime example of another nation that needs improved governance. Having promised at the Plaza hotel to decrease the ratio of current account surplus to GDP, Japan wanted to increase domestic demand and imports, and decrease exports. Increasing money supply was the easiest way to do this, as it hurt no vested interests. The government and voters in Japan chose this, and Japan experienced the bubble and the two 'lost decades'. Still today, policy is drifting with no sense of direction in Japan.

The story applies to the USA as well, where the voting public and the government endorsed a system in which the ratio of average CEO pay to average worker pay grew to 300, from around 30 in 1965. At the same time, non-wage costs such as pensions reached unsustainable levels in the motorcar and other industries. Instead of making unpopular changes to remedy the situation, low income earners were given the false opportunity for home ownership by lax regulation and new financial instruments. The result was the near global financial meltdown originating in the USA.

Looking beyond the EU, Japan and the USA, all democracies have some room for improvement in governance. Another way to put it is to say that we all need to improve the way democracy functions. As Sir Winston Churchill famously said, democracy is the worst form of government, barring all others that have been tried from time to time. Too easily, the system can turn into one of handouts to the loudest (who are often the richest) constituents, at the expense of others.

This is especially dangerous in a mature society such as those found in the USA, Japan and Europe where social security, unemployment insurance and pensions are well-established. Ageing is another characteristic of such a society, pushing up the ratio of contributions and taxes as percentage of national income. Voters in such a society vote for politicians who promise to lower taxes without lowering social protection. The politicians try to find the money to do this by either issuing government bonds or boosting tax revenues through higher growth. But higher growth is not easily achieved in mature societies because they come with mature economies which have high labour costs and satiated consumers. Another way to increase economic activity is through deregulation and reform, but voters seldom vote for politicians who promise pain. The popular way out is monetary expansion (lower interest rates).

In Japan, interest rates were lowered to boost domestic demand and lower the ratio of current account surplus to GDP. In Europe, low interest rates came with the euro carrying the credibility of the Deutsche Mark. In the USA, low interest rates were maintained because of the 'Greenspan put' (the Fed's readiness to lower interest rates every time the markets showed signs of strain), and the Fed's concentration on consumer prices rather than the financial and real estate market indices. In each case, the result was a bubble which eventually burst, leaving us with unsustainable levels of leverage in both the private and public sectors. In the meantime, financial institutions went bankrupt or nearly did so, interbank markets froze up, and people lost jobs, houses, lifetime savings and opportunities.

VII. A Greek Lesson in Democracy

The natural reaction is to want to avoid a repetition of such a crisis. Unfortunately, a repetition is likely without significant reconsideration of how democracy works, at national and supra-national levels. The crisis was a Greek lesson in democracy. And Europe is leading the way, in the sense that it is showing the rest of the world what they may be tackling with in the coming decades. Europe is revealing a fundamental problem in integration. Democratic nations will not participate in integration unless they retain at least some sovereignty, but integration will not work unless they cede some sovereignty. The problem is that the two sets of sovereignty sometimes overlap. This is a problem that all nations of the world will face with increased interdependence.[18]

At the national level, politicians need to explain to the voters about the choices they face, and voters need to understand the trade-offs. We cannot keep opposing tighter financial regulation on account that it lowers profits, at the same time as asking for economic stability. Similarly, we cannot keep welcoming inexpensive imports while refusing to compete with ‘foreign low-wage workers’. To make the painful reforms palatable, not only the state but also firms and families need to prepare the necessary safety-nets. Reform is costly. But if we do not pay the necessary cost and yet demand higher economic activity via expansionary policies, the result will be another bubble and crisis. With the current levels of fiscal deficits, which government can dispense the funds for salvation if the world is on the brink of a crisis again?

At the supra-national level, nations need to recognise the need for harmonization, especially in areas such as finance where ‘regulatory arbitrage’ is comparatively easy and rampant. After the London Summit in 2009, the sense of urgency and co-operation seems to have evaporated, as nations busied themselves preparing their own versions of financial reform. For reform to go forward, it needs to be tailored to national conditions and compromise is unavoidable. Yet, if the composite global effect is not taken into account, the result can be quite different from the one intended at national levels. If one region banns certain types of dangerous financial transactions but another does not, contagion ensures that all parts of the world are hit once things go wrong.

Thus global governance needs to be re-examined. Most people would agree that a global government is a long way off. At the same time, most will also agree that the status quo is unacceptable. Economies are becoming more and more mutually interdependent every year. A gap is developing between the ‘realm’ over which a national government has jurisdiction and the ‘area’ in which economies are integrated. This suggests the need for more supra-national authority.

There are two layers to the problem. The first is that there is no effective supra-national body to which democracies will cede their national rights.

The second is that even if voters accepted loss of sovereignty to such a supra-national entity, if the latter did not make good use of the sovereignty given up by nations, stability and prosperity will not be achieved. In order for the supra-national entity to effectively use the sovereignty given up by national citizens, they need to be represented. How will voters be best represented in a supra-national body? In the EU, Chaffin and Spiegel (2010) report that the European Parliament is displaying the power gained since the Lisbon Treaty came into force. This may mean the EU is becoming more ‘democratic’. Even though the voter participation rate in their elections falls within the 30% to 40% range, in as much as the European Parliament does represent the people, it is progress in democracy. But we will see what a more vocal European Parliament means. More democratic means more voices, more diversity, more difficulty in agreeing on one policy.[19] That kind of difficulty is probably healthy for democracy but dangerous in terms of market reactions.[20]

But we need to start somewhere, for example with a supra-national entity that ensures mutual consistency in regulation. Such an entity could also be a forum for information exchange, where all participants come to share a common understanding of the state of affairs.

A crisis is a chance for change. Recovery is obviously good, but it has the unfortunate tendency to foster complacency, retard change and invite the next crisis. At the time this paper is being written, a double-dip recession is feared in the USA, doubts over the solvency of some banks and governments are prevalent in Europe, and the yen goes north while the stock market goes south in Japan. Nowhere in the 'rich' countries is there much room left for fiscal or monetary maneuver. Perhaps the silver lining in all this is that it engenders a sense of urgency for improving our democracy.

Notes

[1] This paper is based partly on a presentation made at the meeting of Keio Jean Monnet Workshop for EU studies in July 2010. The author would like to thank the audience for the comments and questions, and Professor Katsuhiro Shoji for his suggestion to expand it into a paper for this journal.

[2] According to Barber (2010), this was not news to EU policymakers. As early as in July 2009, the then Commissioner of monetary affairs Joaquin Almunia had circulated a memorandum to European finance ministers predicting the Greek budget deficit will likely soar above 10% of GDP. But nobody took any effective action. As Barber's article implies, this fact, along with the malfunctioning of the Stability and Growth Pact, reveals the need to improve governance.

[3] The Theory of Optimum Currency Area was developed by Robert Mundell, the winner of the 1999 Nobel Prize in Economics. Mundell (1968) stated that whether a particular region should introduce a single currency depended on whether factors of production (such as labour and capital) were mobile across borders within that region, and thus was an empirical question. We will come back to the OCA theory and its relevance to the euro.

[4] There remains the question of 'orderly default' by members who do not embrace policy discipline. We return to this issue in the following sections.

[5] Mature economies such as Japan or EU members should rely on reform and deregulation in order to create new demand and supply, rather than the more politically palatable monetary and fiscal expansion. This point is related to the need to improve governance discussed below.

[6] This is not to say that this is ideal. Ideally, an economy will have fiscal discipline and solid domestic demand at the same time.

[7] The qualification 'in general' is added because there may be instances where all three can be attained by chance. For example, if the ongoing exchange rate just happens to be consistent with the monetary policy of the countries involved, then even with no capital controls the exchange rate can remain stable.

[8] Before the euro was introduced, many argued that Europe should not lose exchange rate flexibility because it was not an Optimum Currency Area. As it later became painfully clear, labour mobility is not high enough to smooth out differences in economic activities within what is today the euro area. But this does not mean the theory of OCA should have been, or was, a guide in deciding whether or not to introduce a single currency in Europe. As early as in 1990, the European Commission carefully analysed the OCA theory and concluded it was not going to be their guiding principle. See Box 2.3 of European Commission (1990), page 46, which concludes by saying '(s)umming up, the optimum currency area approach provides useful

insights but cannot be considered a comprehensive framework in which the costs and benefits of EMU can be analysed'.

[9] The EFSF is the €440bn facility set up in May 2010 to bail out Member States in financial difficulty. It was reported that expiring this facility in 2013 was a German idea. The Germans had always been against the idea of a European monetary fund of this type, for fear of constantly finding themselves in a position of helping profligate members. Sometime after the establishment of the EFSF, it seems Germany decided it was in their interest to have a permanent institutional arrangement that allowed the EU to handle such bail-outs in an orderly manner.

[10] Chaffin, Peel and Wilson (2010). According to this FT article, President Trichet's office 'insisted that the report by EU finance ministers to the bloc's leaders should say: "The president of the ECB does not subscribe to all elements of this report"… A spokesperson for Mr Van Rompuy confirmed that a note on Mr Trichet's concerns would be included in the report but declined to comment on its specifics.' We should also remember that whether or not sanctions were made automatic, there is still the question of what sanctions serious enough to hurt would mean to an economy that needs to recover and bring down its public deficit/debt to GDP ratio. There remains also the question of what to do about private sector leverage.

[11] According to Spiegel and Chaffin (2010), 'leaders essentially pushed any decision on voting rights down the road, saying Mr Van Rompuy should examine the subject at an unspecified later date'.

[12] Germany's insistence on a treaty amendment is understandable, since the German constitutional court in Karlsruhe is likely to rule illegal a "crisis resolution mechanism" which threatened the stability of the euro.

[13] The Belgian presidency (in April 2010, before their presidency began) requested the European Economic and Social Committee to draw up an 'exploratory opinion' on the open method of coordination and the social clause in the context of Europe 2020. The result can be found at http://www.eesc.europa.eu/?i=portal.en.opinions.10551

[14] As this paper is being written, Portugal's socialist government and the main opposition party are struggling to avert a political and financial crisis by striking a deal over a tough austerity budget. The talks reportedly collapsed once already, and parliament is scheduled to vote on the bill during the first week of November.

[15] A cruder way to put this might be 'elites pulling along the ordinary people'.

[16] Dyson and Marcussen (2010) and Le Cacheux (2010) in Begg (2010) discuss the increased resort to differentiation in macroeconomic governance within the EU.

[17] Begg (2010) and the papers included in the same volume discuss the EU's 'legitimacy' and economic and political governance. What we learn from the EU's difficulties and successes can and should be applied to a wider global context.

[18] Ten years ago, Rodrik (2000) had already extended the 'inconsistent triangle' into one that he called the 'political trilemma of the world economy'. This time the three nodes of the triangle were (1) international economic integration, (2) the nation-state and (3) mass politics.

[19] According to Chaffin and Spiegel (ibid.), Carl Haglund, a Finnish MEP from the Liberal Democrats group says that "Every MEP in this house probably has an opinion on this package".

[20] Financial markets react far more quickly and massively than other markets. This gives us reason to rethink as an option capital controls and other controls on financial transactions.

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