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# Governance after the Great Crisis
# Japan's Experience and the EU[1]

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## Introduction

In this paper, we analyse the ongoing 'great' crisis in Europe and suggest that its fundamental cause is bad governance, or malfunctioning of democracy. We refer to Japan's experience with financial crisis and put forth the argument that the fundamental cause of both crises is bad governance. By bad governance, we mean the kind of governance which leads to implementation of expansionary policy without opening opportunities for productive use of newly available funds.

We discuss this in three steps. In the first step, we look back on how the current crisis started, and move our focus to Europe. We argue that neither the euro nor external imbalances are the cause of the crisis. In other words, removing the euro and/or external imbalances will not eliminate another crisis. The euro enabled members to enjoy low interest rates, but low interest rates do not lead to crises if the borrowed funds are put to productive uses that do not generate bubbles. Similarly, external imbalances do not lead to crises if they do not create bubbles. Bubbles cause crises because they burst and lead to default and destruction of balance sheets. Leverage, be it private or public, national or international, is not dangerous as long as the borrowers do not face the risk of default.

Having argued that neither the euro nor external imbalances are to blame, we indicate

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some common economic facts behind financial crises in the second step. Due to these facts, financial markets are inherently unstable, and the possibility of crises is impossible to eliminate. Japan in the mid-1980s had the Plaza accord, recently in the USA (and to some extent Europe) there was the financial wizardry epitomised by the sub-prime containing CDOs, and the euro area had the low interest rates. It is possible to blame these specific factors and construct a reasonable story for each of these crises. Yet, behind each of them are common facts dictated by economic logic.

Given that financial markets are inherently unstable, bubbles easily develop when funds are poured into financial markets. And funds flow into financial markets when returns there are higher than anywhere else. If reform sprouts new industries and ways to raise productivity, the wealth generated by expansionary policy can find attractive returns in these new areas. This can lead to increased tax revenues and improved fiscal balances. But reform hurts vested interests, and voters often vote for politicians who promise growth without pain. So governments seeking to stimulate growth conduct expansionary policy instead of reform. In order for voters to support reform, they must see that the benefit of reform is larger than its cost. This is why governance has to improve. To borrow a common phrase, 'it's the governance, stupid'.

In the third step, we examine the efforts made in Europe to improve governance. The importance of governance is recognized in Europe, more than in any other part of the world. However, the emphasis is on governance at the EU level, such as the Stability and Growth Pact and Europe 2020. For governance at EU level to become effective enough to ensure stability, Europe needs something stronger than peer pressure and Open Method of Co-operation. For European citizens to accept this, governance has to change at national level as well. National governments may have to cede to supra-national entities and implement stability-oriented policies. There may have to be a major re-think of the European social model.

Implementation of reform is a question of stability. Without reform, doing away with the euro and external imbalances will solve nothing. European citizens must ask themselves how much sovereignty they are ready to give up for the sake of overall stability.

This question is also very relevant to Japan, and in fact the rest of the world. The best macro-prudential and micro-prudential arrangements will not minimize the risk of another crisis, as long as policies to increase growth do not lead to productive use of funds. If a national government is unable on its own to implement policies other than those that risk another crisis, then a supra-national intervention may be the only answer. For such an intervention to be accepted in a democracy, governance must be such that voters see the

cost of insisting on sovereignty to protect their vested interests. If not, it will be the markets that implement the required adjustment. As economies around the world become increasingly interdependent, voters all over the world will be facing the same question that European voters must now face.

The European crisis is a lesson in democracy originating in Greece, which teaches us the importance of asking citizens how much sovereignty they are ready to give up in order to have overall stability in an interdependent world. In this sense Europe remains a model for the rest of the world.

**The Great Crisis**

On the 15th of September 2008, Lehmann Brothers' 160 year history came to a close. Markets responded violently to the news of the biggest bankruptcy in corporate history. One trillion dollars was wiped off the US financial markets in just *one* day in September 2008. The folding of Lehmann was preceded in March by JPMorgan Chase's purchase of Bear Sterns, and coincided with Bank of America's purchase of Merrill Lynch. The US government was eventually forced to bail-out AIG, and then the whole financial sector by a 700 billion dollar fund (Troubled Asset Relief Program, TARP, initially voted down by Congress in September 2008) to buy up toxic assets. Understandably, none of the policy authorities were prepared for such an unprecedented series of events. In the eyes of the markets, they were not decisive or quick enough. Mistrust and fear took over, and financial intermediation froze up completely. Global trade was disrupted, with some resorting to barter. Unemployment soared. Policy interest rates were cut towards zero, where they were not there already.

In the UK, problems had actually begun nearly one year earlier. By September 2007, HM Treasury had authorised the creation at the Bank of England of a Liquidity Support Facility for Northern Rock, and guaranteed all of Northern Rock's deposits and most of its unsecured credit. In February of 2008 Northern Rock was nationalised, as the first of a series of nationalisations. In April of the same year, the Bank of England launched its swap scheme (Special Liquidity Scheme, SLS) to allow banks to swap for UK Treasury bills their high-quality mortgage-backed and other securities.

Continental Europe and Japan initially did not see themselves as the main players, even as they watched with horror the events unfolding in the Anglo-American world.

To this day, Japan has not become the main player of this 'great' crisis, in the sense that Japanese balance sheets were less plagued by the sub-prime loan containing CDOs. The whole process was actually something of a déjà-vu to the Japanese, many of whom saw

with a strange mixture of shock and satisfaction. Japan was not special after all, this time in its failings. If a country allows a financial and property bubble to develop, the bubble will burst one day, financial intermediation will freeze and the economy and markets go into a free-fall. This was the picture of Japan in the 1990s, and now it was clear that the USA and Europe were no different. But any room for schaden-freude or 'I told you so' evaporated as shrinking world trade began to hit hard on the Japanese economy.

Europe was a different story altogether. It soon became the epicentre.

By September of 2008, real estate and financial bubbles began to explode in Europe, beginning with Iceland and Ireland. As every Japanese knows, this could only be followed by damaged balance sheets and taxpayer funded rescues. Governments began to take ownership of troubled financial institutions. In October 2008, two major banks in Iceland (Glitner and Landsbanki) were nationalized, the Dutch Government took over Fortis Bank Nederland, the German authorities announced a package to save Hypo Real Estate, BNP Paribas agreed to take control of Fortis' operations in Belgium and Luxembourg as well as the international banking franchises. Then in October of 2009, a new, Socialist government led by Prime Minister Papandreou came into power in Greece. By November, 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].

This and the subsequent bank take-overs in Spain, Portugal and Ireland put the focus squarely on the euro. Budget deficits began to expand. The acronym PIIGS (Portugal, Ireland, Italy, Greece and Spain) was once again appearing frequently in the news. After rescue packages[3] and initiation of budget cuts and reform, markets seemed to calm down for a while. Then the European Summit of 29th October endorsed a Franco-German plan for the European Stability Mechanism (ESM), a permanent mechanism to replace the European Financial Stability Facility (EFSF) after 2013, which included plans to make private bondholders share the burden of bail-outs[4]. This shocked and confused bond

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[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 is one more fact that reveals the need to improve governance.

[3] On April 12th 2010, the euro area committed to providing up to 30 billion euros in loans to Greece over the next year. The IMF promised support of 15 billion euros. But more bad economic news and downgrades followed, and yields on Greek government bonds continued to climb. On 7th May, the IMF and EU announced a 110 billion rescue plan for Greece. Two days later, after 11 hours of talks, the EU finance ministers agreed a 750 billion euro stabilisation scheme, comprising government-backed loan guarantees and bilateral loans worth up to 440 billion euros (provided by euro area members), a further 60 billion euros (by all EU members through an eixisting facility), and IMF loans of up to 250 billion euros.

[4] This requires reopening the EU treaties, and to increase the chances for ratification the changes

holders, many of whom thought that the new rule may apply to bonds currently sold or held. Irish bond yields spiked. They rose even higher on the 10th of November, when LCH.Clearnet, a large European clearing house, raised the amount of indemnity against default for investors using Irish bonds as collateral. The following day, German Chancellor Angela Merkel poured oil into the fire by repeating that German support for ESM depended on plans to make private investors pay in any bail-out. On the 12th, finance ministers of Europe's five largest economies calmed things down for a while by saying current euro area bondholders were not affected by this plan.

But by the end of that week Ireland was under heavy pressure to accept a bail-out. The main reason was the cost of salvaging Irish banks. The European stress-test conducted in July of 2010 did not implicate any Irish bank[5]. Soon it became clear that this test was not very serious, because within four months, two Irish banks (Allied Irish Banks and Bank of Ireland) had to be bailed out. This is sadly similar to Japan in 1998, when the government gave a clean bill of health to all 21 banks tested in their first test, only to nationalise two of them (Long Term Credit Bank and Nippon Credit Bank) roughly six months later[6]. On 27th November, European Union finance ministers signed off on an 85 billion euro bail-out package for Ireland and approved the outlines of the new ESM. Reflecting the urgency, the proposals for ESM were accelerated from the original December deadline. By this time there was talk of contagion to borrowing by Portugal and Spain.

At their summit in Brussels on 16th December 2010, EU leaders approved an EU treaty amendment, yet to be ratified by all 27 member states, to create the ESM. They also vowed to do 'whatever is required to ensure the stability of the euro area as a whole'.

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are to be as small as possible. Germany's insistence on a treaty amendment is said to come from the likelihood that the German constitutional court in Karlsruhe will rule illegal a 'crisis resolution mechanism' which threatened the stability of the euro.

[5] The Committee of European Banking Supervisors (CEBS) set the pass mark of capital ratios at 6%, and then each country applied its own stress tests to their banks, both for a "benchmark scenario" and an "adverse scenario". Seven banks out of the 91 tested failed, with a total capital shortfall of 3.5 billion euros. Only one Greek bank, ATEbank, was among the seven. The others were five Spanish cajas (public sector savings banks) and Hypo Real Estate, the now nationalised German bank.

[6] In contrast, the stress tests of 19 large banks conducted in the US in May 2009 put an end to doubts about US banks' balance sheets. According to Larsen and Wagstyl (2009), 'for Tim Geithner, (the US stress tests) have brought "unprecedented" clarity; to Peer Steinbrück, they are "worthless".' As for the UK, on 28th May 2009 the FSA put out a statement (http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/068.shtml) explaining their stress test methodology. According to this statement, '(s)ince the FSA's use of stress tests has not been a one-off exercise, but instead embedded in our regular supervisory processes, the FSA will not, as a matter of practice, be publishing details of the stress test results'. The statement also disclosed that 'Britain's stress-tests presumed a peak-to-trough fall in GDP of over 6 per cent, unemployment at just over 12 per cent and a 50 per cent peak-to-trough fall in house prices'.

Officials from Germany, the Netherlands, Sweden and Finland are reported to have emphasised the importance of fiscal austerity, and buyers of euro area sovereign bonds will come under collective action clauses from 2013. On the same day, the ECB manifested a similar commitment by announcing it would increase its capital from €5.8bn to €10.8bn by the end of 2012, which was 'interpreted as giving the bank greater ability to keep buying distressed bonds of countries such as Greece, Ireland and Portugal'[7].

**The euro, external balances and the crisis**

As of December 2010, some people are still talking about a possible break-up of the euro area[8]. In the past year, the CDS spreads over German bunds on have risen six-fold for Portugal, five-fold for Greece, three-fold for Spain and Ireland, as rating agencies downgraded the hapless governments. Many blame the euro for the crisis in Europe, arguing that the euro should not have been introduced in the first place, because the euro area was not an Optimum Currency Area[9]. But given the high economic interdependence in Europe, abandoning the single currency will not enhance stability 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 havoc of the type Europeans are familiar with from the pre-euro years, 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.

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[7] Spiegel (2010). According to Munchau (2010), the collective actions clauses mean that 'if a government cannot service the debt, it can agree a haircut with a majority of investors --- with legal force for all investors, including those who disagree with the majority vote'.

[8] Münchau and Mundschenk (2009) remind us that expressions like 'the break-up of the eurozone' and 'leaving the euro' are not to be used too lightly, because for EU members that meet the criteria (and do not have an opt-out), adopting the euro is automatic. A member state cannot 'leave the euro' without leaving the EU.

[9] 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.

Even if some members did indeed leave the euro area, before long these members will again try to stabilise the exchange rates of their currencies against the DM. Given the EU members' interdependence and the credibility of the DM, it simply cannot be otherwise.

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[10]. 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 more 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 to avoid downgrades or defaults. The low interest rates brought by the euro to GIIPS (a less offensive acronym for Greece, Ireland, Italy, Portugal 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.

Needless to say, it is foolish to contract policy immediately after the crisis. But in order to have a successful and sustainable economic union, undisciplined monetary or fiscal

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[10] The situation is delicate enough in Europe today that some find the word 'discipline' offensive. The author was suggested at a conference in December 2010 that 'discipline' gives the impression of something imposed from above and the word 'framework' should be used in its stead. In this paper 'discipline' is not thus replaced because the use of 'framework' in this context is not yet widespread and may become a source of confusion. The appropriate expression may be 'self-discipline'. Use of the acronym GIIPS (a less offensive acronym for Greece, Ireland, Italy, Portugal and Spain), apparently increasingly common, was suggested at the same conference.

expansion is not an option, for Germany or for any other member state. None of this will change by abandoning the euro. Too much policy discipline leads to recessions. But this fact is also independent of whether we have the euro.

Thus it is wrong to blame the euro for the current crisis. What about external imbalances? Criticism of German style austerity comes with the call for lower saving and higher consumption in surplus countries such as Germany. A country with a current account surplus has a capital account deficit, it is lending more than it is borrowing from abroad. The US current account deficit and the German, Japanese and more recently Chinese current account surpluses are collectively called 'global imbalances' and accused by some as being one of the causes of the crisis[11]. The argument is that because surplus countries continue to have 'excess saving', that enables deficit countries to keep borrowing and that lowers global interest rates. Low global interest rates led to excess leverage and bubbles. Here again, the proponents of this argument seem to assume that low interest rates always create bubbles. In order to stop bubbles from developing again, so the argument goes, global imbalances have to disappear.

It should not be difficult to see that low interest rates do not have to generate bubbles if the borrowed money is invested in ways that do not generate bubbles. As for external imbalances, even if they were eliminated globally or within Europe, bubbles can still develop and crises still occur, if conditions are ripe. Eliminating imbalances will not help if saving decreases in one country and increases in another, only to be used in creating another bubble. We will come back to the inevitable economic factors that lead to bubbles and crises below.

**Sovereignty vs. Stability?**

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 sovereignty over monetary policy 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 the 'inconsistent triangle' mentioned above. 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

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[11] Obstfeld and Rogoff (2009) report that 'the global imbalances did not cause the leverage and housing bubbles, but they were a critically important codeterminant'.

general[12]. 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[13]. The benefit that the country or region gets in return is 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).

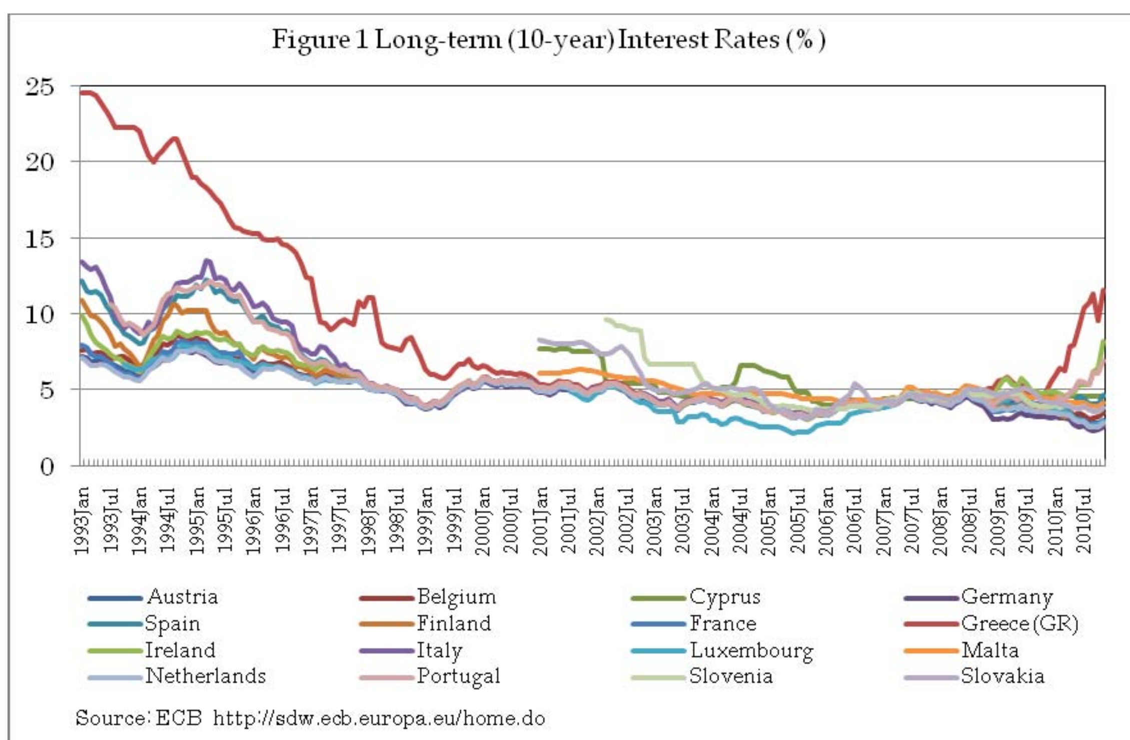

Figure 1 Long-term (10-year) Interest Rates (%)

Once discipline is achieved and reflected in lower interest rates, that cannot be the end of

[12] 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.

[13] 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'.

the story. Self-discipline must continue. Only if wages and other production costs are kept under control, and public and private funds are used productively, 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 some euro area countries. 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. But in some members the funds were poured into real estate and related 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.

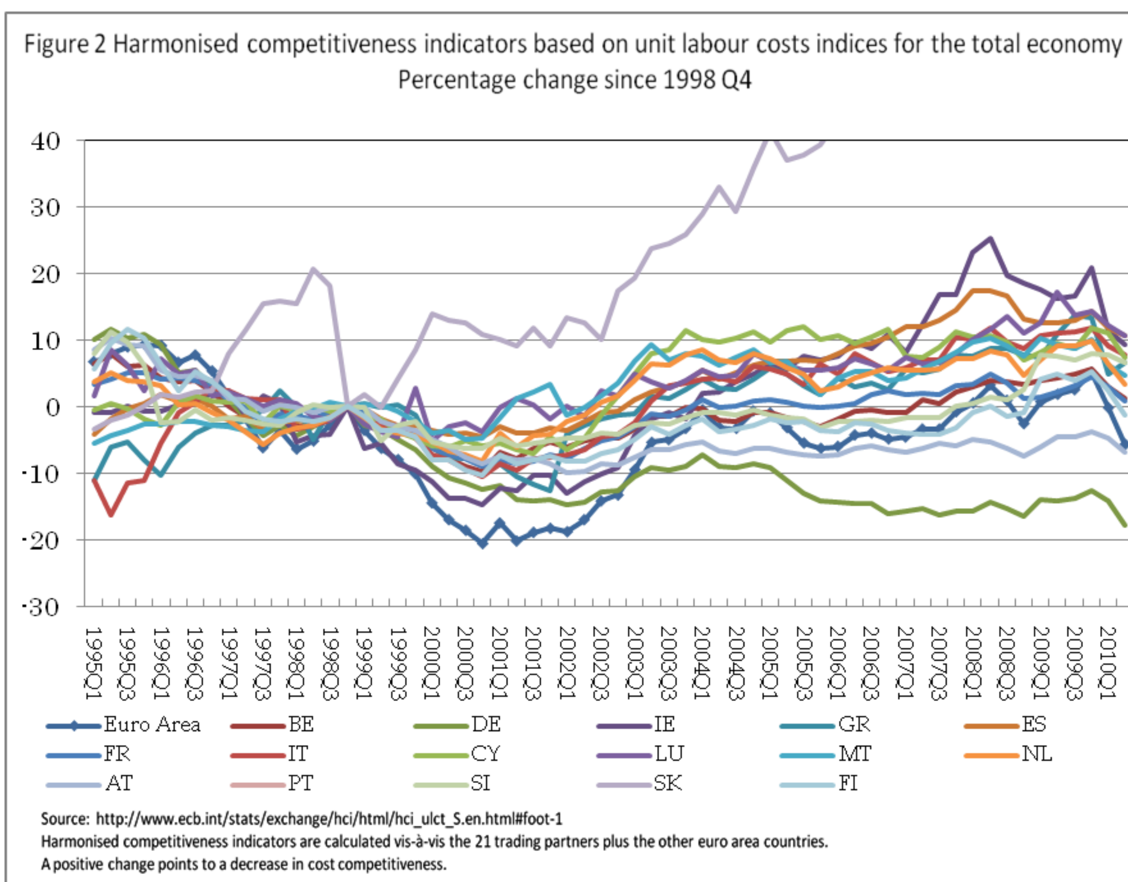


Figure 2 Harmonised competitiveness indicators based on unit labour costs indices for the total economy
Percentage change since 1998 Q4

Source: http://www.ecb.int/stats/exchange/hci/html/hci_ulct_S.en.html#foot-1
Harmonised competitiveness indicators are calculated vis-à-vis the 21 trading partners plus the other euro area countries.
A positive change points to a decrease in cost competitiveness.

In other words, the low interest rates enjoyed after joining the euro did not reflect the true strength of some economies. Figure 2 shows the change in the ECB's Harmonised Competitiveness Indicators (HCI). These HCI represent the competitiveness in intra- and extra- euro area trade, of a country's products compared to those of its trading partners in

terms of the exchange rate and unit labour costs. According to the ECB's webpage from which the data are taken, the HCIs are 'constructed using the same methodology and data sources that are used for the effective exchange rate for the euro'[14]. For intra-euro area trade, changes in HCI are due to relative changes in labour costs because nominal exchange rate does not change. For extra-euro area trade, nominal exchange rates change, so these changes in HCI reflect changes in nominal exchange rates and labour costs. We can see from the figure that compared to Germany, the world's largest exporter until taken over by China in 2009, the countries facing difficulties today had done a poor job of controlling labour costs.

These countries are in trouble because they enjoyed the benefits of low interest rates without doing their homework. The homework was lowering costs. 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. In that sense 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 of 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 '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. The current crisis is a message that members need to reconsider. 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 (by the markets or by a supra-national authority). The Stability and Growth Pact was supposed to encourage self-discipline, but didn't do so sufficiently. Effective implementation of this kind of supra-national pact needed much better governance.

The euro was also supposed to encourage reform by facilitating price and cost comparisons across borders. But price and cost comparisons did not become as transparent due to differences in tax rates and other national regulations.

The current crisis tells Europeans that it is time to think seriously about what they are ready to give up for the sake of integration. Given that the member states are democracies,

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[14] http://www.ecb.int/stats/exchange/hci/html/hci_ulct_2010-04.en.html According to this webpage, '(w)hile the HCI of a specific country takes into account both intra and extra-euro area trade, the euro effective exchange rates are based on extra-euro area trade only. Therefore, the HCIs and euro effective exchange rates reflect different phenomena and are not directly comparable'.

it is up to the European voters to decide.

And this question is not just for the Europeans. The question is relevant all over the world, as economies become more and more interdependent. 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.

**Common economic factors behind crises**

With focus on the euro in Continental Europe, the financial crises on the two sides of the Atlantic may appear to have different sources. Yet, this is only in appearance. Certainly, the direct causes that triggered the crisis in the USA and Europe (and Japan) are all different. But if we turn our eyes to the more indirect causes, similarities emerge.

The direct cause of Lehmann's collapse was their purchase of Archstone, a real estate company, just before the real estate bubble crashed. And Lehmann's collapse played a huge part in starting the crisis in the USA. The indirect causes of the US crisis were lax regulation of mortgage lending, the 'Greenspan put' (the Fed's readiness to lower interest rates every time the markets showed signs of strain), the Fed's concentration on consumer prices rather than the financial and real estate market indices, too much leverage by financial institutions and households, the 'originate and distribute' model and the innovation in financial and computer technology which made that possible. There was also hubris, on the part of the bankers, regulators, policymakers, economists, analysts and sellers and buyers of financial instruments.

We can see that some of the indirect factors, notably hubris, are common to Europe before the current crisis, and Japan twenty years ago. After all, many in Europe did buy into the hype of the new financial instruments, and increased leverage. And the euro had just celebrated its first ten years as the second most important currency in the world. Nobody thought of the euro as anything but a solid currency. As for Japan, back in the late 1980s the world was buying a book entitled 'Japan as Number One', everyone seemed to admire the Japanese production system and Japanese financial and non-financial companies were expanding all over the world.

At a more fundamental level, the commonalities are even stronger. The fundamental causes of financial crises are found by taking away area-specific factors such as mortgage regulation, household saving rate, the importance of the financial industry, currency unification and external imbalances. The fundamental factors are dominated by economic logic, which is why they are shared by every region of the world. In other words, financial crises can happen anytime, anywhere, because economic logic makes them

inevitable.

This may sound too dismal. Economic crises destroy jobs and industries. Everything should be done to avoid them. Yet, it remains true that the economic facts are such that causes of crises are very difficult to remove[15]. Here are the economic facts.

I. The fundamental nature of financial markets

Because of facts 1, 2 and 3 below, financial markets are inherently unstable. When greed overtakes fear, markets rally, and when fear overtakes greed, markets plunge. In either case, buying and selling activities accelerate price changes and encourage further buying and selling in the same direction 'until the music stops'.

I-1. Prices in financial markets change rapidly and massively, because buying and selling financial products can be done in a second by merely typing on a key (low cost of transactions, high speed of adjustment).

I-2. Financial transactions always involve uncertainty and risk. This is because of 1 above, and because borrowers always have more information about him/herself than the lender (asymmetric information).

I-3. Financial institutions have an incentive to take risks that they may not be able to handle (moral hazard). This is because no economy can survive without financial intermediation. The institutions that engage in financial intermediation know that they will always be saved by taxpayers.

II. Constraints faced by monetary authorities

Without abandoning the goal of domestic price stability, monetary policy cannot be expected to keep stability in either the financial markets or exchange rates.

II-1. In general, policy cannot aim at more than one goal at the same time (Tinbergen's theorem). If monetary policy is aimed at domestic price stability, it cannot also aim at stability in financial, real estate or other markets.

II-2. If monetary policy is aimed at the domestic economy, it cannot keep exchange rates stable when capital controls are removed (inconsistent triangle).

II-3. The exchange rate stability that a country gains by giving up monetary policy autonomy (inconsistent triangle) comes with the loss of nominal exchange rate devaluation as a means to increase exports and improve the growth rate.

III. Limits of financial regulation

[15] Since economists can remain economists without winning votes, our margin for telling the stark truth is wider.

Financial regulation may be one way to minimise the risk of a financial crisis, but the following difficulties get in the way.

III-1. Regulatory arbitrage is relatively easy for financial institutions (because they do not need to move huge factories in order to change residence) while harmonisation of financial regulation is difficult because each country has its own domestic interests, and philosophy about financial regulation.

III-2. Tighter regulation tends to discourage financial intermediation. For instance, making private investors pay (even partly) for public bail-outs discourages private investment in bonds and other vehicles of financial intermediation.

III-3. New types of financial instrument are developed in order to cover risk or to take advantage of risk. As long as there is risk, if one instrument is forbidden by regulation, another will be developed to take its place, to cover that risk.

IV. From financial to economic crisis

The following economic facts easily turn a financial crisis into an economic crisis.

IV-1. Financial intermediation freezes up in a financial crisis, but an economy cannot function without financial intermediation.

IV-2. An exchange rate is the relative price of two monies, and is another financial asset price that can change massively and quickly. When exchange rates swing wildly, international trade and investment are disrupted because these cannot be done without using exchange rates (unless inside a common currency area).

IV-3. When a currency is attacked by markets, interest rates must be raised to stop capital flight, just when they need to fall to encourage economic activity and fight an economic downturn. When a government loses credibility, its cost of borrowing increases just when the government needs to refinance its borrowing. Fiscal spending must be curtailed and taxes must be raised, just when fiscal stimulus is needed to fight an economic downturn.

V. From economic crisis to lost decades

An economic crisis triggered by a financial crisis is not easy to get out of. And even if an economy succeeds in recovering, that is not the end of the story.

V-1. Financial crises lead to fear for the future in two ways. The nominal value of wealth goes down dramatically. At the same time the prospects of future tax increases are higher, because governments increase spending on rescue packages. When consumers and firms prefer to save for the future, spending cannot be easily induced. The expectation that prices will be lower tomorrow further encourages consumers and

firms to defer purchases. The result is excess supply and deflation. Stopping deflation is like pushing on a string.

V-2. Both prices and deficits can get into a downward spiral.

V-3. After the crisis, expansionary policy to induce recovery saws the seed for the next crisis.

Few of these facts can be changed by policy. To differing degrees, these facts contributed to every financial crisis and the resulting economic crisis.

Because these basic economic facts cannot be changed, the best we can do is to minimise the frequency and magnitude of financial crises. Unfortunately, the development of financial and computer technology create a force countering such efforts. Nevertheless, efforts must be made to change what can be changed in the right direction.

Markets will not attack stable economies. Where there is no risk of default, there is no downgrade and no capital flight. So the first order of business is to maintain economic stability. The reason why this is easier said than done is because politicians aim at increasing growth. There are legitimate and less legitimate reasons for this. The less legitimate reasons are winning votes, campaign contributions and even illegal favours. The legitimate reasons are;

1. to avoid inter-generational conflicts
2. to avoid intra-generational conflicts
3. to avoid international conflicts (beggar-thy-neighbor situations)

Unless the economy grows, today's retirees' only choice for survival is to eat off tomorrow's retirees. And unless the economy grows and the pie gets bigger, one sector of the economy cannot get bigger without taking away from another. This applies nationally and internationally. Unless there is growth in the global economy, one country's export expansion is another's export contraction. When most regions of the world have excess supply, export expansion is a beggar-thy neighbor policy, whether or not it involves competitive devaluation.

Given that growth is necessary, expansionary policies are also necessary. But they need to be implemented along with measures that allow the additional income to be spent in ways that do not create bubbles.

Imbalances and low interest rates do not necessarily create bubbles, misuses of funds do. The question is not how to decrease leverage, private or public, national or international. The question is how to improve governance so that policies that lead to productive use of borrowed money can be implemented. In other words, it's the governance, stupid.

**European Efforts to improve Governance**

The Europeans are aware of the need to improve governance, at least at the EU level. 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[16]. 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). As noted above, the treaty change was approved at the EU summit in December 2010 but is yet to be ratified by all 27 EU Member states.

Chancellor Merkel's apparent climb-down on the automaticity of sanctions was not at all popular with some smaller Member states such as 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'[17]. 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

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[16] 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.

[17] 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.

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', was cited time and again in explaining 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 was not Germany's intention. At the summit held on November 28th and 29th, Chancellor 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[18]. But Ms Merkel got what she asked for in terms of the renegotiation of the EU treaties.

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' (as shown in Figure 2 above) 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 (OMC), 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 OMC 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'[19].

In terms of efforts to avoid another crisis originating in the financial sector, the EU now has new institutional arrangements. On 2nd 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

[18] 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'.

[19] For an analysis of the Lisbon Treaty as a wake-up call to EU citizens, see Kaji (2007). 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

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.

The EU's efforts at improving governance are significant, not for what has been achieved already but for how difficult it has been to even get this far. The current crisis is arguably the most serious since the EU's inception. Many uncertainties remain. Portugal may require an EU-IMF financial rescue. Debts of Greece, Ireland and Portugal may need to be restructured. Europe's banking sector may need further cleaning-up. The collective action clause of the European Stability Mechanism (ESM) is sure to discourage purchase of bonds issued by peripheral governments after 2013. Plans floated by Italy and Luxembourg to issue Europe-wide bonds, not welcomed by Germany, needs to be discussed. So does the Belgian suggestions to increase the size of the eurozone bail-out fund from the current 440 billion euros. European policymakers certainly have their plates full with these immediate tasks at hand.

Yet no matter how these urgent issues are resolved, it remains true that the probability of another crisis must be minimized. For this, Europe needs to ask deeper questions. This unprecedented crisis may be calling for a fundamental re-think of the European model. Implementation of reform is not just a question of prosperity. It is more a questions of stability. For the sake of European stability, national governments may have to cede to supra-national entities and implement more stability-oriented policies. This may involve a major reconsideration of the European social model, which ironically is already beginning in a brutal manner in countries experiencing severe budget cuts. Markets are imposing the adjustments which governments were only too reluctant to. European citizens must now face the question of how much sovereignty they are ready to give up for the sake of overall stability.

**Stability requires good governance**

Governance is not an exclusively European issue. Japan is a prime example of another nation that needs improved governance. Japan after the Plaza accord had two choices in responding to the call for increased domestic demand. One choice was to deregulate, thereby creating new effective demand and opportunities for productive investment. But deregulation hurts vested interests. So Japan took the other choice, monetary expansion.

The newly created purchasing power was not put to productive use because the only lucrative investment was in stock and real estate markets, and a bubble developed. All voters welcomed the higher wealth, until the bubble burst. Still today, Japanese politicians (both in and out of power) are avoiding bold policies that may hurt in the short-run but will bring new opportunities in the longer-run.

Looking beyond the EU and Japan, all democracies need to improve the way they function. 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, democracy can turn into a system of handouts to the loudest (who are often the richest) constituents, at the expense of others. Often, the protection of vested interests is justified in the name of sovereignty. In mature societies such as those found in the USA, Japan and Europe, 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 economies which have high labour costs and satiated consumers. As argued above, another way to increase economic activity is through deregulation and reform, but voters seldom vote for politicians who promise pain. The result is monetary and fiscal expansion.

Democratic nations will not participate in integration unless they retain at least some sovereignty, but stability requires ceding of certain 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[20].

Both politicians and voters have responsibilities. Politicians need to explain to the voters about the choices they face, and voters need to understand the trade-offs. Voters need to ask themselves whether their cherished social model is conducive to stability. They also cannot keep opposing tighter financial regulation on account that it lowers profits, at the same time as asking for economic stability. Similarly, they 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,

[20] 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.

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?

If a national government is unable on its own to implement policies other than those that risk another crisis, then a supra-national intervention may be necessary. For such an intervention to be accepted in a democracy, governance must be such that voters see the cost of insisting on sovereignty to protect their vested interests. And as economies around the world become increasingly interdependent, voters all over the world will be facing the same question that European voters must now face.

The European crisis is a lesson in democracy originating in Greece, which teaches us the importance of asking citizens how much sovereignty they are ready to give up in order to have overall stability in an interdependent world. In this sense Europe remains a model for the rest of the world.

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