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DECODING THE EURO CRISIS: ITS PAST AND FUTURE

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P R O C E E D I N G S

MR. VAISSE: I think we're on. So, we're going to get started.

Hi, everybody. My name is Justin Vaisse. I'm the director of research for the Center on the U.S. and Europe here at Brookings. And it's really my pleasure to welcome all of you this afternoon at Brookings for a conference on the ongoing, unfortunately, euro zone crisis.

"Allowing the destruction of the euro is to take the risk of the destruction of Europe. Those who destroy Europe and the euro will bear the responsibility of resurgence of conflict and division on our continent." These are the words of French President Nicolas Sarkozy just yesterday sort of dramatically raising the stakes of the upcoming summit of the Ecofin Council and the Euro Group, the European summit that will happen on Sunday, October 23.

But today just a couple of hours ago, President Sarkozy flew to Frankfurt for an emergency meeting with the leading players of that crisis, namely German Chancellor Angela Merkel; European Central Bank President Jean Claude Trichet; as well as Christine Lagarde, the head of the IMF; and a couple of other leaders, as the French and the Germans apparently remain at odds over the comprehensive package of measures that is supposed to be presented and agreed upon on Sunday.

Our aim today in the conference is to go beyond the headlines and try to take a step back and make sense of the euro zone crisis, its origins, its actors, its mechanisms, and its impact on America. We will also try to discuss -- that's the hard part -- what the most likely scenario for the future is.

I would add that today's conference is really a Brookings-wide initiative with, you know, basically two parts of Brookings collaborating: European -- I'm sorry -- Economic Studies with my colleague, Doug Elliott, on the one hand, and Foreign Policy Studies with Carlo Bastasin and myself for the Center on the U.S. and Europe. And you know, obviously we didn't want this to be purely endogamous, so we extended the

invitation to our friend and colleague Ted Truman from the Peterson Institute, who I will introduce at greater length in just a moment.

I would add that Brookings has done -- has already produced other things on the euro zone crisis. Publications by Carlo, by Doug, also by Domenico Lombardi and a couple of others, and they are now gathered on the same pages -- specifically dedicated page on the Brookings website.

And also this conference is really the first in a series that we are planning. So, the second one will be just two weeks from now at the same place, at the same time on Wednesday, November 2. You can mark your calendars already. And the theme of that second conference will be the European Central Bank and the new role that it has assumed during the euro zone crisis. And of course, the occasion will be the changing of the guard of the president from Jean-Claude Trichet to Mario Draghi on November 1, just a day before. So that's Wednesday, November 2. And then there will be a third conference on the euro zone crisis probably in early December, but we've not decided yet and we'll see if there's still a euro zone to talk about. No, it's a joke. (Laughter)

I will now briefly introduce our speakers. We have two very -- three very qualified speakers, and I will very briefly introduce them in the order in which they will speak because they have a lot to say. And I'm sure you have many questions.

Doug Elliott was an investment banker for two decades, principally at JP Morgan. He was also president and principal researcher for the Center on Federal Financial Institutions, which was a think tank that he headed. At Brookings he focuses on issues surrounding both public and private financial institutions, and he has been working quite a bit on the euro zone crisis in the recent month, including regulatory reform, the role of the banks, and other important issues.

Carlo Bastasin is a nonresident senior fellow at the Center on the U.S. and Europe and in the Global Economy and Development Program here at Brookings. He's an editorialist for *Il Sole-24 Ore*, the Italian business newspaper. He's a specialist of

the European political economy.

And I would add, he's putting the finishing touches on a book entitled, *Saving Europe: How National Politics Nearly Destroyed the Euro*, which will be published by our own Brookings press in early 2012, a couple of months from now. And it's sort of an insider account of the euro zone crisis, starting in 2008, for which he got extraordinary access to the main policymakers, European policymakers, in Germany, in France, and elsewhere. And I must say, because I've had the privilege to read it, that it's sort of a breathtaking narrative mixed with great economic analysis.

Now that the commercial is done, I'll move to Ted Truman. Ted Truman -- no, but I sincerely recommend the book in advance. Ted Truman is a senior fellow at the Peterson Institute for International Economics just across the street from here, and he's been working there from 2001 after serving as assistant secretary of the Treasury for International Affairs from 1998 to 2001. Previously, he directed the Division of International Finance of the Board of Governors of the Federal Reserve System from 1977 to 1998. And I would add from '83 to '98 he was one of the three economists on the staff of the Federal Open Market Committee. And he will offer remarks after Doug and Carlo.

So, Doug? Why don't you start.

MR. ELLIOTT: Thank you, and thank you all for coming here today.

I'm going to do the easy part of this, which is to try to give an overview of what the euro crisis is, how it came about, what the key issues are that we'll face, and I'll leave the really hard stuff to the two qualified people who are up here. And Justin almost said there were only two of us qualified. (Laughter) And I'm sure I know which two.

But so let me start with what do at least I mean when I talk about the euro crisis? I'd say the principle attributes of that crisis are, we're talking about a sharply increased risk of default for at least a set of the euro zone countries. That results in a number of risks to the banking systems in the euro zone, which, as with almost all

countries, are heavily invested in bonds of their own sovereign.

There's also related to this what I think is a small probability, but a probability of one or more countries leaving the euro. Any of these things -- defaults or movement out of the euro -- has potential severe knock-on effects in the euro zone and of course beyond the euro zone. I'd also add on a medium- to longer-term basis the euro crisis is also about the implications of competitive imbalances within the euro zone. The difficulties that Greece, for example, has if you think of it kind of as a business in the modern world.

Now, why do we care, particularly here in America? Well, Europe is likely to have a severe recession if things go badly wrong. In the worst cases, I'm certain they would go into quite a severe recession. It would create a host of political problems within Europe, and the recession over there would certainly translate to a recession here, and probably a significant slowdown of growth in China. They'd probably go from, say, 9 percent growth a year to 5 percent growth a year. But given that they're designed for much higher growth, they'd have their own problems out of this.

And the financial markets would be hurt very badly across the world. We've already seen intimations of this in the way the U.S. and other world stock markets have gone down substantially at times when the euro crisis was most scary.

Well, what caused the euro crisis? Again, I have the benefit of speaking just at very high level here, but it's a complicated mix of economic, political, and market confidence factors. It's not any one, it's a combination of all.

Starting with the political -- or I'm sorry, the economic, the euro zone's design was inherently flawed. This was fairly well-known at the time. I would venture to say, most of the founders were aware to at least some extent, but felt that there would be opportunities to correct the known flaws along the way without the kind of pain that we're, in fact, going through.

Currency unions only really work if the countries are very similar, or if

they closely integrate in order to be able to handle things as one unit. But politics prevented close integration at the beginning, and politics are still preventing -- making it difficult to create much more integration now, though some progress has clearly been made.

One of the underlying political issues which I think most people would agree is that "Europe," the European project, has been an elite project for the most part. Governments, academics, business leaders, people at the top of society have been very strongly supportive of the European project in general, whereas the mass of the public in many countries have had their doubts. Germany is probably at one extreme in that respect, in that while the Germans certainly entered willingly into the euro zone, much of the public was very reluctant to give up the Deutsche Mark because of worries of the type of thing, for example, that is happening now.

And so part of what this has meant -- the difference between the desires of the people at the top and the general wariness of much of the public -- is that politicians have gotten to the point where I would argue in places like Germany they're faced with a choice of being executed by hanging or by firing squad. And the choice really is they can do things to bring greater integration of the euro zone, but that are things that are very unpopular and lose the election that way, or they can go the other way of losing the election and let the euro zone fall apart, which I would argue is almost certain to produce a fairly severe recession, which is also not an easy way to get reelected.

Now, if you face politicians or really anybody else with two choices, both of which are unacceptable, they will search rather desperately for a third choice. And in this case, what it's tended to mean is that we've had partial solutions. So, each time that we've had a phase in the crisis, what we've had is first denial, then a gradual acceptance that this really is a crisis that isn't going to go away, and then the governments at the last possible moment have done the least they can do to still deal with the crisis. And

politically, that's probably been the smart thing, though not necessarily, but it certainly isn't the way to get to the right long-term answer. And since what's happened is each time the crisis has come back because they haven't dealt effectively with the totality of the problem, it just gets harder and harder.

I also mentioned market confidence. Let me underline the importance of that. It wasn't that many years ago that the market foolishly felt that there was no reason to distinguish the creditworthiness of the different euro zone countries. There were very modest differences in price, but not much. The assumption I think, A, was nothing terrible was going to happen in the world and, B, if something did happen in the euro zone, the whole euro zone would be behind whatever country was troubled.

The market has swung to the opposite point of view now. The market has quite possibly overshot, but in any event it certainly does not have great confidence that the European leaders will do what's necessary. Now to underline that this is a market confidence issue, look at Japan. I'm not an expert in Japan, but the debt ratio there is something over 200 percent. You're talking about very high levels of debt, and yet everyone is quite confident that the Japanese will continue to be able to pay their bills and you really have not seen issues with them. So, market confidence does matter. It can take a bad situation and make it worse. It can take a bad situation and make it easier to deal with it.

Now, how do we solve the crisis? Obviously if I knew all the answers, I would probably be somewhere else and not talking to you now, but I do believe there are some broad themes of what would have to be true for the answers to work.

First, I believe from the investor side -- and not everyone agrees with me -- I believe the investors are reaching the point where they will demand what are effectively cross-guarantees. They will need to know that the resources of the entire euro zone are behind Italy or Spain or whatever individual sovereign that they're looking to buy the bonds of. Because they're no longer comfortable that the kind of informal

guarantees, camaraderie, whatever you want to call it, will hold.

Now there are multiple ways this could end up being done. You could have so-called euro bonds that are effectively guaranteed, join several liabilities for the whole euro zone. You could have the European Central Bank doing massive interventions that effectively put the resources of the whole zone in there. You could have some version of the various stabilization mechanisms that have been created that could borrow from the ECB, or have independent resources that provide the funding. There are multiple ways of doing it, but I think investors are going to demand, ultimately, that the euro zone stand behind its members or say it's not going to, in which case I think things will get far worse.

In exchange for that, should that happen, strong countries will very certainly demand strict constraints on the fiscal policies of the weak. And one of the difficulties in figuring out how to make these solutions work is that part, figuring out how to have the quid pro quo, the tight fiscal integration, the careful constraints.

I also think that politicians, based on voter desires, will demand that private sector investors who have chosen to buy these bonds do take losses, not just in Greece, where that will pretty clearly happen, but in other cases as well that they share in the burden. Part of what that will mean is that the banks in the euro zone will need shoring up, and there are steps that I think will be taken shortly to try to prepare for that.

Many of the critical things I'm describing are very complicated and from a legal point of view, particularly the way the euro zone is set up, would often require treaty changes. So there are a lot of complications here.

So let me just end by saying that while I believe that things will get significantly worse before they get better, I do believe we'll get to the point where the governments do what they will ultimately have to do. I think the odds are fairly high that the crisis will be solved without a disaster scenario, by which I mean widespread defaults or countries pulling out of the euro zone.

The reasons that I think this will happen is there's a very strong political will to keep the European project working and there's quite compelling economics. Now that they're in the euro zone, backing out would be fairly disastrous. Having said all that, let me be clear. I personally think there's maybe a one in four chance of a quite bad outcome. I'm not trying to say there aren't risks here. The problem is, we need many, many, many things to go right, and each of the things has a very low probability of not going right but there are so many of them you get to an appreciable total risk.

So thank you. Let me turn it over, Carlo.

MR. VAISSE: Thanks. Thanks, Doug. That was great.

While Carlo is transitioning to the podium, I will say to the people at the very end, there are about 20 seats here in the front. So please, stand up and come here in the front while Carlo is getting ready, because you're certainly not very comfortable. So please come here. And we feel quite lonely here in the podium.

And I will thank --

SPEAKER: Unless they want to leave early.

MR. VAISSE: And I will thank Doug very much for his remarks, which I interpret as seeing the euro crisis -- I mean, the current pain as being sort of birth pangs rather than death throes, right? Of a sort of more -- a different euro zone probably, but which is sort of seeing life in a very painful way.

So, while we let the other -- the last participant sit, we'll turn over the floor to Carlo. Carlo?

MR. BASTASIN: So, good evening, everybody. And thanks to Doug for the important remarks he put forward. You see the difference of perspective. If he knew all the answers, he would probably be intellectually satisfied. If I knew all the answers, I would still be stuck in the euro area crisis as an Italian.

Well, let me say from the first as far as the broad question, which gets raised time and again about the survival of the euro, let me say from the outset that I'm

pretty convinced that the euro will survive this crisis. And the reason why is basically that the backbone of the project, which is the political will of governments and of the European public opinion, is probably stronger than 6, 12, or 24 months ago. The European Statistical Office produced a set of polls on the attitude of the public opinion showing that almost 90 percent of the European citizens are in favor of stronger coordination as a solution to the crisis, as opposed to national solutions.

And even one of the crucial observations that Doug advanced about the attitude of the German citizens shows that the hypothetical return to the Deutsche Mark is now envisaged by a declining share of the population, a share which has been declining even during the crisis.

So, still the crisis is extremely dramatic. One way to see it is by comparing the euro area situation with the U.S. Because in principle, if you will look at the figures and the fiscal position of the U.S., you would see that the deficit in this country is higher than in any country in the euro area, and the debt would rank as the second highest in the euro area.

Still, all the attention is focused on the euro and not on the dollar, and there are several and serious reasons for that. The first can be found watching the debt composition of the debt in the euro area and in the U.S. Basically the share of private investors in the U.S. debt is limited to share of 14 percent -- 1-4, 14 percent -- while the relative figure -- the equivalent figure for the euro area ranges from 46 to 67. It's 48 in Italy, it's 66.2 in France. Evidently, private investors are a very fickle category of investors who tend to run very rapidly, optimizing in the short term the balance between risk and reward while public investors tend to be steady hands, to -- and have an intrinsic interest in keeping -- in holding the status quo.

That's probably why when Standard & Poor's downgrades the U.S., no match seems to happen, while when it downgrades Spain or France only envisaging that -- or Italy or Greece, the whole euro area seems to crumble down. Those investors can

very rapidly shift from one of the euro area countries to the other without having currency cost, without changing the profile of currency risks. By doing that, they produce a problem in the provision of liquidity that the country of concern is facing. Obviously there is no national central bank which can compensate for the liquidity shortage, and in a very rapid time the liquidity problem can turn into a solvency problem.

So basically, that would explain -- would be a way to explain the crisis in terms of the relatively use of the currency. The euro is a relatively young currency, has not established its credibility among the steady hand investors. But this is also mirrored by the share of the debt which is held by central banks. I guess the share in the U.S. debt is around 36 percent, 18 percent directly by the Federal Reserve. In the UK, the Bank of England holds 20 percent of the British public debt. In the euro area, the share of the European Central Bank, even after the Securities Market Program, is probably less than 4 percent. But this brings a second structural weakness in the euro area, which is the lack of a central bank which is offering consistent provision of liquidity to the single states. Well, it has been intentionally conceived.

So actually as you know, at the end the European Central Bank steps in when the crisis threatened to slip out of control, but it does that reluctantly following a strategy that a monetary economist would brand as constructive ambiguity. Actually, when markets get nervous and where risk aversion increases, there is nothing constructive in this ambiguity, unfortunately. And that leads to a third structural point, which posts signs -- difference between the euro area and the U.S., which is, obviously, the lack of well-defined and legitimate political responsibility behind the euro area.

As we know, the EMU -- the European Monetary Union -- was conceived in this way as having a monetary policy centralized and decentralized fiscal policies. And why that? Well, first of all because the European Union is a treaty-based institution. It's based on a set of rules, which is both super-national and intergovernmental. And the reason to keep the intergovernmental side well alive was based on the fact that there was

no taxation at the common European level, and evidently the responsibility for fiscal policy necessarily had to rest on the national governments.

But a rules-based system works well during periods of good weather, but it works pretty badly when the weather turns bad, and exceptional circumstances after the global crisis were indeed very bad weather. So the crisis affected immediately banks, as we have heard. But banking regulation, for the same reason as fiscal policy, remained under control of national authorities. So the banking problems transferred into public debts, which assumed specific national differences and enhanced the divergences inside the euro area. And the reason the national control on the banking system is basically because of political interest. Banks have a very special role in the European economy, different from the role they have in the U.S.

Well, it was even more difficult to reconcile everything under a political common commitment because of, what we could say, a philosophical pillar of the European Union which is based on an organizing principle called a subsidiary. Subsidiary is a category which is derived from the Catholic tradition of decentralizing the decision, taking them at the level -- taking at the central level only the decision which cannot be taken at least at an equivalent -- with equivalent effectiveness at the decentralized level.

But evidently, once you have this organizing principle of decentralization, to bring back the competencies you need a crisis, and that is exactly what is going on, an effort to recentralize some competencies which had been left to the national state.

So, we are now in front of a very decisive weekend. On Sunday, there will be an EU Council summit, which should provide for a new comprehensive solution. And if we connect the dots of the problems we have been describing, well, the solution would be simple. You need to have the ECB to provide the liquidity as a backstop for the national state problems, and the national states commit to fiscal union. But all this is farther down the path. We are still far from that.

To reach fiscal union, we will have to set up the institutional framework for that, change the treaties, and that will take years. In the meanwhile, we are left with a rather timid arrangement. Probably the ECB will keep on purchasing stressed government securities, and what is the probably -- the likely outcome of the summit will be not the ECB buying the stressed securities, but basically governments setting up a system for ensuring investors against losses that they may incur investing in government securities.

It's all too slow-burning stuff, probably, but that will keep alive the two methods that have characterized this crisis. On the monetary policy, it was constructive ambiguity, as we have seen. That is, not to compromise too much the ECB. But on the political side, it will be its equivalent, which I call the policy of uncertainty. The policy of uncertainty is a kind of two-pronged strategy that has been supported by the German government especially in the absence of a common political authority.

The only way to manage and to enforce discipline in other countries was, on the one hand, to ensure the firm commitment of Germany and of creditor countries in the euro. And on the other hand, to leave it to the markets to enforce the discipline in the other states. There was, by the way, no ready political authority to employ for this aim, and so markets played this role. It is a very dangerous strategy, and we have seen it, but, paradoxically, it is actually working with governments. Fiscal policies are very much in line with the German requests. Everybody is making all that is possible to reduce the fiscal deficits in the countries, even in Greece.

It is still to be proved that it is enough to please the markets, and we'll probably see starting from Monday. But as I said, eventually the political determination is there. And I can reasonably see that countries will bend over backwards to defend their currency, having seen the problems that they would face without it.

Thank you.

MR. VAISSE: Thanks, Carlo. Ted?

MR. TRUMAN: Well, thank you. I guess speaking for someone who comes from across the street as well as across the pond relative to Europe, it's a pleasure to be here and collaborate.

I've been reminded recently of the attitudes in the late 1990s when the Europeans were coming to create the final steps of putting the euro in place. And they complained that we in the United States were not taking the whole project very seriously, on the one hand, or were saying that it would fail on the other.

Today, at least you can say on the first point that the Europeans can't complain that they were not paying attention to their activities anymore, and it may well be true that some of the euro skepticism may have been warranted.

So I'll, too, have a few words to say on the past, present, and future. I think it's easier just rather than to comment on things just to make sort of -- summarize my points, which I think largely will be complementary, not entirely.

So, the past, I think, two points that I would reemphasize would be that -- the incompleteness has been emphasized by others, the incompleteness of the euro construction, institutionally on the one hand, essentially, a currency without a government. And in terms of public opinion, in the sense that it -- the general public did not -- they thought that this was going to be win-win for everybody all the time, all benefits and no costs in the project, and that has proved not to be the case.

I see in terms of the crisis -- this again will be a slightly different take but not, I think, orthogonal to what you've already heard -- four basic elements. So -- and I'm thinking more in a sort of narrow crisis mode, which is where I worked, unfortunately, most of my time.

You have the financial crisis in the euro area, which started in some sense with the global financial crisis that it affected some in the euro zone, EU, non-euro zone EU countries. And then it affected Greece a couple of years ago, almost two years ago now, and it spread to a number of other countries. And I think in retrospect one

would say that if people had acted decisively and -- more decisively in May of 2010, we wouldn't be where we are today.

But each country is different, but they're each similar in the sense that they need to stabilize their economies, their financial systems, and their public finances. And -- I think this is an important point, I don't think disagreed with around here, but underemphasized in terms of they need to start growing. And if you're worrying about debt ratios, you have to worry about the nominator as well as the numerator.

Second, there needs to be a creation of what's called a firewall with respect to the rest of the euro zone. That involves financial support from institutions like the ECB, at least temporarily. Various mechanisms like the European Financial Stability Facility, alongside the IMF. And there is the risk that the structures that are now there -- and I think that's all they have to play with at the moment -- are insufficient to the multiple tasks that have been put before it. And this is one of the reasons why you find this talk about leveraging the ESFF, and Carlo just mentioned the insurance -- using to ensure debt issuance as one possibility.

Third, you have the mention, the banking and financial system. In some sense, I'd -- Doug is the resident expert on this panel on that one. But the basic issue is that if banks are going to take large losses, the question is whether they can absorb those losses and remain soft. The answer is, no, or at least we aren't sure. And that aspect of it has, in turn, affected decisions by the European authorities because they don't want to go down that road and find out what would happen. And the problem is, it may be -- this may be the most negative point on the panel you've heard so far -- it may be too late to act effectively on that point.

And then lastly you have the part of the crisis, the sort of existential crisis in terms of the euro and the euro zone, addressing the incomplete institutional structure and reeducating the public about what's required to make it work.

The problem, basically, is it's difficult to reconstruct a structure when it's

under attack, right? To rebuild a house when it's on fire, right? To repair the leaking roof when it's raining. Choose your own analogy.

And, therefore, there are implications for short-term crisis management because decisions are taken, in some sense, in the crisis context in the view that are colored by the nature of the longer-term debate and their various feedback effects there: issues of moral hazard, how much you share sovereignty, how you generate public support.

So, for the future I see sort of -- I mean, I'm going to give you my version of the three basic scenarios. I think there is 25 percent -- I think that was basically what Doug said, took him down right -- that there will be a full-blown crisis. Not enough will be, you know -- in some sense, that the structure will not work. Or it takes too long to do the kinds of things that need to be done and, therefore, the whole system breaks down.

And there are many ways this can happen, whether it can be the Greeks balking, failing, quitting, right? Or similar political failures or -- elsewhere. Or the political processes that failed to put in place the elements that are needed in time to stop the rot, or a run on financial institutions or a run on the euro. And depending on how serious that full-blown crisis is -- you know, above 6 on the Richter scale, if you want to put it that way, or 7, 8, or 9 -- you could have ultimately a fragmentation and breakup of the euro zone, and I think that's possible.

Lastly, the second is the sort of -- the other extreme is the comprehensive solution, 25 percent. That might be -- involve a nicely, nicely, nicely debt restructuring for at least Greece, probably Ireland, maybe some other countries, at least partially in those countries; continued financial support for the ongoing fiscal adjustments and structural reforms in the countries under crisis; a well-constructed firewall for other countries using the ESFF and the ECB in some combination. And I think something that hasn’t been mentioned, economic policy actions, regular conventional economic policy actions in the ECB, they could lower their interest rates 150 basis points and get down

where the rest of the world is. They're going to have an important question before them about whether they -- not just whether they take fiscal support actions, if they're going to go into recession, but whether they allow their automatic stabilizers to take effect, which are very powerful in Europe.

You have the need for creating a safety net for financial institutions. I have this gut feeling, which may be wrong, that we're too far gone for just garden variety capital injections. And if you really get a crisis, you're going to have essentially a euro zone solution that involves in some sense ring fencing the retail operations of banks, and then doing a triage about who should succeed and not succeed, without using the principle of we support our banks, not your banks, which is essentially how the system works now.

And then you'll have to have -- and this is an important component -- a commitment to reconstruct the economic governance structure. And I think this is the point that sometimes in my view is missed. If you're going to have institutions like the ECB, and even some political processes, building a bridge over this crisis to something else, it has to be something on the other end of the bridge.

And the problem, I think, is seen from -- speaking as a former central banker, though not for the ECB, of course -- you know, the other pier of the bridge hasn't been there yet, and so they are unwilling to walk out on that plank, right, and dip down in the water. And that reconstruction is going to involve -- I think it's been mentioned already -- treaty revisions and constitutional changes. That will take time, but you need some commitment, I think, to get there.

Most likely near-term scenario is you're going to have muddling through. The Sunday announcements will not be as decisive as some people think and hope and wish. It'll be another step along what the Germans are calling a long path with many twists and turns. But it seems to me as I think about it -- and I think that's the implication and inference I draw from the other two members of the panel as well -- ultimately they're

going to end up having to deal with the four elements of the so-called comprehensive solution. The question is, how long is it going to take them to get there, and how much broken crockery there is along the way.

It's clear that along the way you're going to have slow growth in Europe with adverse effects on the rest of the world. That's one of the reasons why the United States is so unhappy about all this. And you will have further negative feedback loops through the financial system, both within Europe and within the world as -- the rest of the world as a whole. I mean, it is remarkable to see the extent to which you've had financial markets and general risk aversion, which is centered on what's going on in Europe, affecting other financial markets, not just here but in other emerging markets, starting, essentially, in the middle of -- at the latter part of the summer.

I think part of this is a projection of 1998, '99 -- 2008 and 2009 onto the market. I don't think history usually repeats itself quite so rapidly. But the point is, that is driving investors and their concerns. And that's, I think, the reason why all this is so important and why, as I sometimes have put it, when the U.S. authorities say what are the principle international economic policies -- issues that are faced by the world today, the first, the second, the third, and the fourth are Europe.

Thank you.

MR. VAISSE: Thanks, Ted. So, one of the aims of this series of conferences is to sort of give you an overview of the crisis. We'll do it next time, two weeks from now, with the ECB. But right now we're focusing on sort of the big picture.

And so I have three questions for our panelists after their introductory remarks, and maybe I'll start with you, Doug. I'm really struck at the fact that, so, this crisis is a sovereign debt crisis sort of entangled in a banking crisis, in the context of either recession in the past year or very slow growth in Europe. And it seems to me that if we had just one of the three, it would be, I would say, relatively easy to solve. If we had two of the three, it would be conceivable to resolve two of these problems, slow growth

and banking crisis or, you know, banking crisis and sovereign in the context of high growth. But the three at the same time seem to me to make a particularly big challenge.

And so, could you address that question on the relationship between the crisis and slow growth? And in particular, the worry that of course the measures that are taken by governments throughout Europe to reduce their deficit will simply kill growth, making the crisis probably more acute than it is now.

MR. ELLIOTT: Certainly. It's a good point, and one that Ted was referencing as well.

There is a close relationship between growth prospects and the depth of the debt crisis -- of the euro crisis. If growth rates in Europe were expected to be higher, markets wouldn't be as worried, people wouldn't be as worried in general. It would be possible to sort of work your way through the problem over time. So the absence of that higher growth is an issue. If we cold get towards higher growth, it would help.

The second aspect which Justin just referred to is, unfortunately, many of the actions to deal with the debt are going to make growth slower. So, cutting back on the amount of government spending or raising taxes, either one generally slows growth. So the things you need to do in the first instance to deal with the debt is going to slow the growth and make the debt more onerous. So, there's a negative feedback effect here.

And certainly, we've been seeing it with Greece. Greece has actually done an awful lot to pull its deficits down, but it's also put its country naturally into a fairly serious recession in doing so, which has made it harder to reach those targets.

I'd also like to mention the tie-in with the banking system in terms of this. Something I worry about a great deal -- in general I do support putting more capital into the European banks quickly, which probably means that the governments will have to mandate it and, in fact, supply some of that capital. So I do overall support it.

But what I'm really afraid of is that it will be done in a way that gives the banks a strong incentive to reduce that new capital by shrinking. Because the way that

bank capital is normally calculated -- the adequacy of the capital -- is by comparing the amount of capital to the size of the organization or to the size of the risks. And so if you're BNP Paribas, for example, or Societe Generale, or any of the large European banks and you want to reduce the amount of capital you're going to have to take on, and the reason you'd want to is because it will come on very bad terms, either from the market or the governments, if you want to take less of it, you want to be smaller. Well, if the banks in Europe basically cut back on loans and try to sell the things they own, you're going to have a lot of pressure on the economy. So yes, I do worry that if done badly this could severely crimp growth in Europe.

MR. VAISSE: Maybe to continue on the banking crisis, because that's one aspect that is probably less well-known than the sovereign debt crisis. You know, generally the narrative about the euro zone crisis is that it all started when there was new government in Greece two years ago, in October 2009, and it discovered that the deficit was way higher than what the previous government had announced. And that sort of set off, then, the euro crisis in general.

So, the question, Carlo, was so when did the banking crisis start to be linked with the sovereign debt crisis? And so, was it part of the origin of this euro zone crisis? And then, how do they relate to one another?

MR. BASTASIN: Well, it's a very good question, and a crucial one. You're right, generally the knee-jerk reaction to such a question would be the euro crisis was originated in 2010 or October 2009. But actually, the first connection between -- the first reaction of the CDS, the credit default swaps, on sovereign debt of the euro area showed in October 2008. It was the case of Ireland, which was bailing out its six largest institutions -- credit institutions. By doing so, providing public guarantees, it created a tension on its public debt and the CDS in Ireland started to react.

Similar reaction started to propagate soon afterward, and for the simple reason since banking resolutions were of a national nature, were delegated to the

national authorities, they impacted directly on national fiscal policies and on the level of national debts. So depending on the gravity of the banking problems, immediately the public deficit differentiated among the countries, and investors were observing them, not anymore as the euro area as a whole, as we say, but as a single object of investments.

And it was the case in January 2009, when some auction of government securities started to fail, not to obtain a full subscription. It was the first case since years in the euro area.

MR. VAISSE: Interesting. Ted, I have a question on the U.S. side of all of this. What can the U.S. do now? The U.S. seems in a position to -- well, to be mostly receiver of bad news. But can it do something to help solve the crisis? Can the Fed act, for example, to help either European banks or the European Central Bank? Can the federal government do something, and should it do something?

MR. TRUMAN: Well, I'll start at the end of your question. The Federal Reserve has, in fact, has acted to reopen its swap lines with European central banks, and actually starting in May of 2010. So at the time the first Greek rescue was announced, they reestablished the swap lines. And it has been recently announced they -- by the Europeans, the ECB, and the Bank of England -- who I think that's all mostly cover -- are reinstituting dollar liquidity provision activities that extend for a year or 13 months, so through the end of or over into 2013.

So in that sense, the Federal Reserve has acted. That's the one thing they can do, if you want to put it that way, they have done to take some of the dollar liquidity pressures off of some of the European banks using, to be quite frank, using the credit standing of the ECB as their counterparty, rather than having to worry about the credit standing of the individual European central banks. Something I might also add is not particularly popular among American politicians of both the right and the left. So, that's one thing that can be done and has be done, and can be done on greater scale and should be done on greater scale.

On the sort of fundamental questions on sort of how they -- how -- you know, the United States doesn't have any overt leverage over this matter. It has -- it can coax and cajole and it can share experience and ideas, which has been done. The Secretary of the Treasury went to Poland in early September, if I remember my dates correctly. It's all a bit of a blur at this point. And I should have put it the other way around. He actually accepted an invitation of longstanding to go to Poland to meet with the European Central Bank finance ministers, the Central Bank governors, an informal meeting to share both U.S. concerns and some ideas about how one could try to address those concerns in terms of the proposals, some of the ideas that -- the mechanisms that we used during the crisis.

And the principle -- other than expressing the view that you have to do -- I think they're two basic points. One is there's a tendency to use two different phrases, to do whatever it takes to save the euro or the euro area, right? And then sometimes you hear it translated as do whatever is necessary. Well, doing whatever is necessary is a sort of defensive posture, right? Doing whatever it takes is trying to get out in front of the problem, right? And this administration -- and I certainly share that view -- is of the view that overwhelming force both on the policy side and on the financial side is a necessary component of a solution. So, that's part of the message.

And then the more technical part of the message is that there are ways, especially when you're limited politically and financially, of trying to scale up your resources, and that's where you get this debate about leveraging the ESFF involved.

And that is something that -- we face many of the same problems in the depths of the crisis. The Congress first voted down and finally voted for the TARP, so the administration -- both the Bush administration and the incoming Obama administration had a fixed kitty to potentially do things with. And the question was how to leverage that to do as much as possible. And some -- and one way to do that was to combine that as, to put it crudely, equity with financing that came from the Federal Reserve, but with the

losses taken on the equity side, at least in the first instance, to have much more firepower. Because at least the way I think about this is the market is using leverage against them.

And in some sense, if we -- speaking as a former government official -- if we the governments all have to appropriate every euro or every dollar that we use and the markets can leverage, right, every dollar and every euro, we are operating with one hand or two hands to hide behind our backs. So, the idea is to sort of have some countervailing force which you leverage with the balance sheet of the ECB, or what some combination of mechanisms, of which there are a large variety, and the equity of the EFSF. There may be a few other things around, but those are the most likely ones, to have some sense that you can convince the markets that you will have enough firepower to sustain the financial program.

And I think -- but beyond expressions of concern and advice, and I think it's fair to say, mobilizing international public opinion, which includes the G-20, broadly, the United States doesn't have any choice but to sit there and hope they get better, because it's affecting us.

MR. VAISSE: Thanks, Ted. I would like now to turn it to you, to the floor. We have a full half an hour for questions and answers. So, there's a mic over there. You know the ground rules, but I'll mention them anyway. Please stand up, please identify yourself, and make sure there's a question mark at the end of your sentence.

Sir, here in the middle. And I would add that we will take three questions in a row and we'll take advantage of Doug being with us, again, for 15 minutes. He has a commitment afterwards. So, direct many questions to him first before then turning to Ted and Carlo.

MR. ORI: My name is Antoni Ori. I'm a consultant at the World Bank. General agreement coming out of this we want to see some kind of European constraint

over national fiscal policies. The question is, would the panelists like to explore what types of form those constraints might take? We tried Maastricht, it was arguably a bit crude, a bit inflexible. Nonetheless, if we had backed it we would have been in a better place than we are today.

What might Maastricht 2 look like? What are the options? What are the pros and cons?

MR. VAISSE: Thanks. In the back over there, Michael.

MR. CALINGAERT: Michael Calingaert from Brookings.

Question picking up a little bit on what Doug said about Greece. Is the international community -- meaning basically the Europeans at this point -- being too harsh on Greece? And is there a danger that Greece will find itself in a position where it simply can't fight its way out, both in terms of political problems, demonstrations, and like more generally feeling among lots of groups that they're being treated inequitably? And then just being able to pay back.

Related to that, what are the prospects for default in one form or another, and is that manageable?

MR. VAISSE: Thanks, Michael. And then we'll take one last question in the back. The sir with a white shirt, just in front of you. Yeah, sir.

MR. SHETLANDS: Hi, Eric Shetlands. Basically my question has to do with looking at the ECB, and you look at an institution that I would say has generally been focused on price stability. And so when you look at this and we talk about what the ECB has done, what it could be doing, and kind of those shortcomings -- whether that be interest rates or whether that be backing liquidity in different nations -- what perhaps institutional reforms can we look at to force ECB to be almost proactive, or at least to be active?

MR. VAISSE: Thanks. Doug, do you want to take first cut at at least one of these questions?

MR. ELLIOTT: Sure. I think I'll touch on two of them, probably.

In terms of Greece, I don't know enough about the Greek situation to have a strong judgment, other than to say there seems to be a clear consensus among the Europeans that the package has to be reworked; that Greece at the moment under the July agreement is being pushed harder than it can actually handle, which is why this weekend they'll probably end up announcing some things that will be more haircuts on the debt, and presumably some other actions to make it a little more feasible for Greece to make the adjustments.

In following up on Greece, in terms of the ability to handle a default, that's a really important question because at one level it's possible to treat Greeks separately because I think almost everyone accepts that at least quantitatively Greece is significantly different from the other troubled countries. So it's at least possible to say here's what we do for them, that's not what we're going to do for everybody else.

The problem is, it may be in degree significantly different, but many of the types of problems that it has are shared to some extent by Italy or Portugal or some of the other countries. And so, investors aren't going to necessarily have a certainty that just because the Europeans say we're going to do this with Greek investors but we're going to protect everybody else, that that's really how it's going to work out in terms of that.

And in terms of the kind of Maastricht 2 stuff, I'll leave that to my two colleagues who are a lot smarter with it. In terms of the ECB, in the short term, anyway, I think the ECB is analogous to the way the Fed was in the financial crisis we went through. It was the place that actually has the money. So, it has a much greater ability to provide funds without having to get treaty changes or national parliament approval or whatever.

So even though it will come -- if it is significantly more active in supporting the efforts, which I think it's going to have to be, it's going to hit a lot of opposition. But right

now, at least, a simple majority vote of the members of the ECB board can take very wide-ranging actions. So I think they'll end up doing a lot in some manner to take funds and provide it, whether that's providing many more bonds on the secondary market, or it's leveraging up one of these other instruments, like the EFSF, or whatever.

MR. VAISSE: Thanks. Carlo, would you like to?

MR. BASTASIN: Sure. I would pick up a few remarks on Greece. Basically what's gone wrong with Greece? We had the experience of the Eastern European countries, which recovered from the worst recession -- in relative terms, it was worse than in the old European Union -- without changing the level of their currency to the euro. So, acting practically as a euro area country and they recovered amazingly rapidly in a matter of less than two years.

And basically, probably we had this experience in mind when we thought that Greece could perform an equivalent recovery once shielded by the worst turbulences. And fortunately, the structural peculiarity of Greece was overlooked. And I'll give you one simple figure. On average, the euro area industry received 65 percent of the profits from abroad, mostly from the rest of the euro area, the European Union. Greece receives -- collects 85 percent of its profits domestically. So, when you produce domestic deflation, you cut wages and you cut prices. Inevitably, you reduce the pretension to invest, and you produce a recession which spins out of control.

Essentially, the category of a closed, small economy relative to open, small economies was an important one to consider, and it was not considered. So now we know that to restructure Greece, it will take much longer than any other country in the euro area. It will take 10 years, probably longer. And Greece has to be shielded, has to be provided with the funding for this period without musing over new access to the markets of the country.

As far as the ECB is concerned, there is a basic principle which has to change. We are still focused on central banking based on monetary stability because

that was a critical experience in the European history, and especially in Germany which gave shape to the monetary union. We're now confronted with a different category, which is financial stability. Financial stability is by itself a concept which requires interdependence. And this changes the frame of mind of policymakers.

MR. VAISSE: Ted, would you like to add something?

MR. TRUMAN: Well, I feel a modest obligation to answer the first question, since the other two have ducked it. And I don't have an answer, but I think the answer is going to involve some variation on the theme of a European fiscal authority, right? But it really is, you know, down the road, right?

A European fiscal authority that can issue its own obligations, whether or not you call those euro bonds, it could be called euro bonds, that's one way to do it. And you use that, right? Has some disciplines that it can apply, but maybe because it has expenditure powers as well as revenue-raising powers to apply to different members. So, that is an incentive system.

And if it's in the business of financing things, right, it has an independent capacity to raise revenues. So, it has the capacity to, for example -- I'm just talking off the top of my slightly empty head -- it has the capacity to, you know, say, okay, 1 percentage point of that taxation receipts that come from the euro area as a whole. It's a small problem about the euro area versus the European Union. But let's talk about the euro area, is now going to be devoted to paying off this debt, right? Which is a way of essentially taxing the system as a whole to a few common objectives, which is, in some sense, the way federal systems operate.

So I think you're going to have to come to some structure now. The question is whether it's a minimalist structure, but it has to be beyond -- it seems to me, the stability of the growth pact, six-pack approach to -- of surveillance plus not very many incentives, mostly disincentives in order to get there.

I guess the only comment I would make on the ECB point is -- I don't

disagree with what's been said. I also don't think that a pursuit of price stability has been what's been holding back the ECB from doing other things in the other area. That's not saying I don't think they were wise to raise interest rates this summer, right? Or in 2008, for that matter. And I do think they would be wise to lower their interest rates today, and that presumably is partly a function of the inflation concern. But I don't think it's been -- that aspect has been the problem that they have had in using other tools to divest the crisis.

In some sense, they have too sharply differentiated between the two things, right? So they say, we run monetary policy, conventional monetary policy, and we do unconventional things to deal with the crisis, all right? And in a way, they -- one would hope that they maybe would spend a little bit -- do a little more on the former, right? Because there is some feedback effect.

So, macroprudential policy is not just worrying about the stability of the financial system, and the fact that in doing things so it doesn't collapse, it actually involves using macro policy to reinforce the financial system. And they basically have declined to use macro policy as much as they could to make it softer, so that you have less of a recession in Europe because interest rates are lower. So, that component of macroprudential policy, I think, has been there. On the other hand, it's been outside the complete discussion of this topic in the last three years. So they probably could be confused.

MR. VAISSE: Thanks. Second round of questions here in the front, sir?

MR. KOROFSKY: Thank you. I'm Bert Korofsky, and I have a question.

During the whole time the Greek debt was built up -- occurred, the banks were authorized or had to do -- had to have against Greek bank lending only 1.6 percent in capital, which means that they were authorized to leverage their capital over 60 times to 1 lending into Greece.

Obviously, it's mind-boggling, generally. But how can you explain that at

this particular moment when just because they discovered that they shouldn't have done it that they're still pursuing strengthening the capital requirements in, let's say, the most inadequate moment for that? Raising the capital requirements right now when the banks don't have capital and they -- you allow them to 60 to 1 and now you want to bring them down to 20 to 1? It's sort of the most --

MR. VAISSE: Thanks, great question. The gentleman behind you.

MR. PREDERGAST: Hi, Joe Prendergast with the Federal Housing Finance Agency.

I definitely just try and relate the different parts of the crisis together, like we've been talking. So I definitely see the large, systemic risk to a Greek default, but trying to think of it in terms of the currency union. Would people on the panel think a default would necessitate Greece leaving the union? And if from an economic, I guess, rather than a political perspective, would that be that catastrophic if one of the peripheral countries left the currency union? And sort of how does that relate to defaults, is what I'm getting at.

Thanks.

MR. VAISSE: Thanks. The lady here in green.

SPEAKER: Hello, good evening. My name is Jana (inaudible). I am faculty at University of California; I am a visiting fellow here at SAIS Johns Hopkins.

So, Mr. Truman already alluded to the fact of how American economists were skeptical, you know, with regards to the euro project at the beginning, mainly because the euro zone did not satisfy the criteria of an optimal currency area. And so we all know that the degree of financial and trade integration was not what the manual prescribed, and over time we've seen a decreased degree of financial degradation, but we still see European economies, you know, exhibiting very different structural characteristics. So we still see this persistent North-South divide. Northern countries being mainly export-oriented, and I would say, fiscally more responsible versus southern

countries, a less fiscally-responsible and probably less, also, export-oriented and benefiting from the cheap money due to high credibility of the euro vis-à-vis, you know, drachma, et cetera, et cetera.

So despite all these prescribed solutions you alluded to, all three of you -- although, you know, the first speaker has left already -- I am just wondering if we really can -- or if the European leaders can somehow come out with a long-term somehow sustainable solution given this persistent divide in the euro zone. And can we somehow maybe take the lessons from the failed currency union, such as Scandinavia and currency -- and Latin currency unions? So can we, you know -- can we really expect that this large -- this comprehensive project will be achieved, given the last week negative vote of Slovakia with regards to bailouts?

Thank you.

MR. VAISSE: Thanks. Ted, would you like to start?

MR. TRUMAN: Well, the first and the last -- second and the third questions, in some sense, I think are related, the second half of the second question.

So, do I think that default -- do I personally think default would lead to departure from the euro zone? I think the answer is no. I mean, it could be. It depends on the political circumstances how that comes about. So if the political processes in Greece, to take that example, say we don't want to pay and we want out, all right. And the only government that can be elected in Greece is one that delivers on those two things, and they're out, right?

But as a technical matter, you could have a -- that's why I put it in my remarks, nicely, nicely write down, a substantial write-down on Greek sovereign debt without having them pull out to having Greece pull out of the euro zone.

I do think that if Greece were to pull out of the euro zone in a -- even in a sort of negotiated way, which is hard even to imagine, but let's put -- out of the euro zone, out of the euro area, go into essentially the European -- whatever, the economic area

arrangement, say, it would be -- I don't want to -- I don't know if such things are sure things, but it would not be -- it would -- I think the possibility of a sequence of events that led to a fragmentation of a moving backward of the European project in all its aspects would be highly -- much more highly probable than I see it today, and if not absolutely likely. You would end up with increased barriers to trade and capital movements and people movements and so forth and so on. And a lot of the integration-type projects which are underway and have been underway for decades would, I think, grind to a halt and go in reverse.

And that comes to your question about, well, it was never doable to begin with or advisable to begin with, because these economies are sufficiently different. I think -- you know, I may be being a bit Pollyannaish. I'm not sure the economists have done a really good job, speaking as an economist, and talking about all this and optimal currency area and so forth and so on. I mean, if you think about the United States it's hard to convince yourself from an abstract sense that this is an optimal currency area. Many of the -- you know, especially since different parts of the country, right? Many of the characteristics that you describe about Europe, whether it's about the economic structure of various parts of the United States or the profligate tendencies, right? Or the poverty or -- the income and poverty distinctions are very much prevalent within the United States.

So, I don't see that as much of a problem as the fact that the political superstructure was not there. So that when the system came under stress, right, there was -- might put it that way -- even less capacity than there is here in the United States. And we know full well that there's not a lot of capacity here within the United States to reach a solution -- a political solution. You did not have the political structures, right, to complement the ECB.

So you have, for example, right, the ECB doesn't have a finance ministry to interlocute with, right, in a crisis, if the central bank and the finance ministry are not --

they don't have to be identical -- if they're not on the same page, if they can't talk to each other about how the problem is going every day, right? So that they know as they move their various levers, right, that they know whether they're complementing each other or not, right? Then you have a problem. And I think that has been the basic problem within Europe in terms of the incompleteness of the -- to raise.

On the first question about -- I mean, there are two issues there. One is, what's the risk weight you put on soverance? That clearly is political, right? So if you're part of the euro zone you get the same sovereign risk as you -- in Germany as you do in France as Belgium, and including Greece. That clearly was politically -- you had to do it.

Second part of your question is, is this the right time to raise capital? I think Doug in some sense answered that question. I mean, if you raise capital or the way it's now being put, if you raise capital and you think about it -- or maybe you did it, Carlo -- in terms of the ratio, right? You can raise the numerator or you can reduce the denominator, right? Reducing the denominator is probably not what should happen, right? So the point is, if you actually -- if the Europeans are going -- so instead of -- inference of, I think, I draw -- is instead of saying you should go from 6 to 10, let's say, right, what you need to do is you need to go from capital where you're given risk-weighted assets, right, which are 6, so the 10 for your current risk-weighted assets, right, at least in the current risk-weighted assets. So you actually are adding to capital rather than reducing exposures or reallocating exposures.

MR. VAISSE: Carlo?

MR. BASTASIN: Well, I fully agree, starting from the question on raising capital in the banks. I think it's not the right moment, and it's not the intention of most European countries, by the way. It was raised -- but evidently they have a problem on the asset side, and it has to be solved politically, as Ted has explained.

And on the liability side we have seen hidden problems as well, and it was mainly the IMF pointing them out because there was a kind of reluctance, especially

in Germany and France.

If you see the Global Financial Stability Report of the IMF, there is an amazing graph that points out how slow they were, Germany and France, to correct the low level of capital. They are really standing out of the rest of the group. Some pressure is reasonable, it's not the right moment. It has to be -- it's an issue that has to be tackled in a more reasonable range of time.

As far as Greece is concerned, I attach a probability slightly lower than zero that Greece goes out of the euro area. But I just have a question. Would you invest in Greece after it's out of the euro area? You need to reintroduce capital controls, first of all.

And think that during the crisis just in the last 2 years, 200 billion of euros have flown out of the country, mainly through tax evasion, that have tried to find a shelter in Switzerland. Would they come back outside -- being outside the euro area? In a different set of rules and laws, I don't think they would. So the only way is staying in and react. That's a very short answer on a complicated question, which I may have not grasped fully. But just an example.

Optimal currency area are not in the category of optimality as idealists may characterize it nor is fiscal federalism. They are the brainchild of human beings, full of failures, and so on.

In Germany, since 60 years fiscal federalism is characterized by a constant stream of money transferred from 3 countries, 3 regions, to the rest of the country. And in the U.S., I guess it's similar, like 5 states providing for the bulk of the transfer to the 47 -- rest. So, some imperfection in the human constructions has to be accepted, I guess.

MR. VAISSE: Thanks. We'll take just two last questions and we'll ask the panelists to respond very briefly. The gentleman here and then the gentleman in the back. And then we'll call it for a close. So, the gentleman here first. Yes.

MR. BRUTER: Alex Bruter with German TV N24.

My question goes -- again, you touched upon the subject, and what the IMF has said about the German and the French banks. And the question is, since this is not only a sovereign debt crisis but also a banking crisis, at least at the European level, do we have a far too big banking sector in Europe? And the weaknesses of the banking sector in Europe has never been addressed. And you raise the question about capital levels, for instance, in France and in Germany since the crisis in 2008.

MR. VAISSE: Good question. Sir?

MR. NIERING: I'm Klaus Niering from UC Davis. I have a question which I would like to put in terms of a counterfactual. If in, let's say, end of the 1990s, before the euro zone was established, if in the crystal ball one could have forecast the coming -- in the current set-up, the coming scenario, how -- the mismatch -- where the strain on -- the mismatch between pointing out the mismatch between the monetary union and the lack of a fiscal union, and then, if one could have gotten -- there was some statement from Mr. Truman, I think, that people in general were quite aware of that, but they didn't take it seriously, let's say they had taken it seriously, there was -- what would the reasonable choice would or should have been?

On the one hand, to say okay, no, the euro zone is unworkable, number one. Or number two, it seems to crystallize, okay, no, we would have had not just a monetary union but also a fiscal union. We would have to have both.

My question is, would that be -- is there a reasonable -- a good case now? Would there have been a convincing case then to argue where, in that case, where we should have done everything. We should have gone for a fiscal union and there would have been support in a broad set of countries for that.

MR. VAISSE: Thanks. Maybe Carlo, you'd like to start? And we'll have to give very, very short answers.

MR. BASTASIN: Yes. I like both questions very much.

Well, the first one in my opinion is, there is a reasonable case for dividing commercial banks and investment sectors. And after having done that, we might discuss if commercial banks are still too big to fail or so on. I don't think so, it's manageable. The crucial point is putting together financial supervision, because what has been really disappointing, it was the financial supervisions in some countries.

The second question, well, let me just say if the stability growth pact, had it been respected honestly since its outset, we wouldn't be in this situation. Now, what happened in 2003 shows not only in fiscal profligacy in other countries -- 2003, the year when the stability pact was violated by Germany and France, with the active cooperation of the Italian presidency of the European Union. Well, after that moment other imbalances show in the graph. Even increasing wage costs in Greece or in Italy or in Spain, there was -- that was a setoff of indiscipline which went beyond fiscal policy.

So, honesty or checks and balances are inescapable, whichever the institutional solution will be.

MR. VAISSE: Thanks. Ted, last word?

MR. TRUMAN: I'm not sure -- I guess I agree, probably, with what you said on the banking system. One has the sense that -- partly because you're talking about national banking systems, which are probably too large for the countries, right? That collectively they're too large for the euro area, right? And they're concentrated within the countries, and in some sense you need more diversification, so forth and so on. So in that sense, I agree with that.

I think on the question of the crystal ball question, except for your qualification I -- my reading of the debates within Europe was that some people looked into the crystal ball -- including some Germans, to be quite frank, like Otmar Issing, right? -- and said, this is incomplete, right, in the governance sense and in an economic governance sense, right?

And if we go down this route, the notion that at some point time will take

care of it, I don't think -- I think that was the image you used, right? Time will take care of it. They said, well, I'm not so sure that we'll be able to adjust as we go forward. So there certainly was -- including, I think, a large fraction of Germany, which is the leading example -- a view that you had to actually have political union, much more in the way of political unions, which wasn't broadly acceptable within Germany at that time. But I think the thoughtful component of the -- thoughtful is probably a little pejorative at this point -- component of the elite actually saw that that was the logical consequence, right?

Now, you had this qualification that it had to be supported, right? But I think again, the answer was -- the answer would have been -- there were two answers. One would have been either don't do it, right, don't go ahead or go ahead as was preferred with a -- comes to the question earlier -- with a very narrow defined group, right? So you don't make the choices that were made -- essentially the political choices -- to start with the euro zone, which was as large as it was. You still would probably have had troubles because you would have had the 2003 fiscal problems. But you compounded the size, compounded with the sort of thumbing of the nose to the structures, right, I think helped lay the groundwork for the subsequent indiscipline.

But mentally -- which is easy to say, by the way, in retrospect, that the failure to build a stronger structure, governance structure, more political integration or more support for political integration, I think is part of what the problem is today. And that's part of the problem why you have to go through 17 parliaments in order to get this done and that third thing done and so forth and so on. And that is a painful process, even by painful U.S. political standards. It's like having 17 Houses of Parliament rather than only 2.

MR. VAISSE: Thanks very much. On this comparison I think we'll call it a close. And please join me in thanking the panelists, which have been great.

(Applause)

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CERTIFICATE OF NOTARY PUBLIC

I, Carleton J. Anderson, III do hereby certify that the forgoing electronic file when originally transmitted was reduced to text at my direction; that said transcript is a true record of the proceedings therein referenced; that I am neither counsel for, related to, nor employed by any of the parties to the action in which these proceedings were taken; and, furthermore, that I am neither a relative or employee of any attorney or counsel employed by the parties hereto, nor financially or otherwise interested in the outcome of this action.

Carleton J. Anderson, III

(Signature and Seal on File)

Notary Public in and for the Commonwealth of Virginia

Commission No. 351998

Expires: November 30, 2012