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PERSPECTIVES FROM THE U.S. AND EUROPE

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P R O C E E D I N G S

MR. SHAPIRO: Hello. If you can settle down, take your seats, that would be helpful. We need to get started, because our guest speaker needs to leave very promptly at 2:15.

Thanks very much for coming. My name is Jeremy Shapiro. I'm a Visiting Fellow here in the Foreign Policy Studies Department, and I am your friendly moderator for this panel -- which I think is going to be very interesting.

I'm certainly going to take a light moderation touch, largely because we have a very distinguished and knowledgeable panel, and, also, because I have very little idea of what I'm talking about.

I think the reason for having this is, we have the very great, good fortune to have Lorenzo Bini Smaghi here, who is a former member of the European Central Bank Executive Board, and intimately familiar with the whole Eurozone crisis and austerity debate that has been going on in Europe for the last three years, and has certain reflections here in the United States.

He has written a book, which hasn't succeeded in getting a physical copy yet, but is available online, on the austerity debate in Europe, which I would highly recommend. I read it last night, despite the fact that I still haven't caught up on all of my *Breaking Bad* episodes. And

I think it was well worth the effort, and I highly recommend it to you. It's really quite fascinating inside account of how particularly the European Central Bank, but, also, the entire European governance system, has dealt with -- or tried to deal with the Eurozone crisis and the implications of that for European integration.

So, we also have, to react to his book, Doug Elliot, from our Economic Studies Department.

And then to give some reflections on how this relates to the sort of eerily similar problems in the United States, we have our very distinguished Senior Fellow from the Governance Studies Department, Bill Galston.

And you can find their bios in the package that you have, so I won't go on at great length.

So, with that, we will hear from the three of them, and then turn it to the audience.

I will remind you, when we get to the question period, you should identify yourself. You should ask a question, and you should not give any *Breaking Bad* spoilers.

Okay, thank you. Lorenzo?

DR. SMAGHI: All right, thank you. Thank you very much for this opportunity -- can you hear me? Yeah -- to present this research, this

book that I actually wrote initially to try to explain to American friends and students why it was so complicated to take decisions in Europe, and why we end up discussing about austerity, which is the worst of all worlds -- or could be the worst of all worlds.

And so this basically were some notes that I had prepared. Then I found out that maybe it was useful, also, for Italians to understand better why we are discussing these issues. So, I translated them in Italian, and wrote the book, actually, in Italian -- and then translated them back in English, with somebody helping me -- again, to try to get a flavor of why Europeans are digging into this issue about austerity.

And I wanted to discuss it not only in economic terms, but, also, in political economy -- trying to understand, what are the incentives of the policymakers when they take some of the decisions?

And that's how my reasoning started -- looking at what happened in Greece, in Italy, in Spain, and observing that, systemically, politicians tend to postpone tough decisions -- and particularly austerity decision, budgetrydecisions. They postpone it because they are unpopular, and that's why they postponing until these measures become unavoidable.

And when do they become unavoidable? They become unavoidable when financial markets are not willing to finance the debt

anymore, and the interest rates on the debt rises to such high levels that the debt sustainability is at risk.

And at this point, when the so-called spread or interest rates become so high, then the citizens, the voters, taxpayers, understand that maybe the worse, these unpopular decisions have to be taken, because there's no alternative.

And this is a narrative which is used both in Southern and Northern European countries. We have to accept these decisions, because they are unavoidable.

Now this, acting in this way, may seem easy and the easy way out for politicians, because they don't take responsibility for explaining to the people why certain actions have to be taken. It's the markets and the situation. Looking into the precipice and looking to the worse is the main political arguments to convince the voters that there's no alternative than austerity.

Now this looks rational from the point of view of incentives, but, over time, it's not very rational -- at least, it doesn't pay off, because, electorally, if you look at those governments which went through this kind of mechanism to convince the voters to act -- well, they have been voted out systematically, if you think about all the examples in Greece, in Portugal, and so forth.

But the fact that this strategy does not pay off electorally makes things even worse, because it pushes politicians to wait even more, and to really decide on the verge of the precipice, when they are against the wall, as I say. And it makes the whole strategy even more risky, because when they are against the wall, it assumes that, there, the citizens will really realize that there is no alternative.

But, you know, this would imply that the actions to avoid the precipice are even bigger, so the austerity is even tougher. And this will ultimately convince people that measures have to be taken, and this is a vicious circle, where delaying, and delaying, and delaying these adjustment measures in the hope that they will look as unavoidable as the least worse -- but all this assumes that people are rational.

So, this game of chicken, as those of who have seen the movie, assume that nothing goes wrong. But things may go wrong, and this is where democracy may be put at risk.

So, this vicious circle -- the first point I wanted to discuss -- is clearly apparent. Politicians act late. They wait -- market pressure. When the market pressure comes, the actions that they need to take to reverse the market direction have to be very tough, very tough austerity measures.

When these measures are taken, maybe some of the pressure is taken out, but then, as soon as the pressure is taken out, the

people react to the austerity measures. They don't like it. They vote out the government.

The next government who comes in, having learned from experience, will delay the actions even more. And this is getting into a loop, which may get worse and worse.

And this is what happens to Greece in 2009, to Ireland -- government systematically delayed going to the IMF or trying to make the necessary adjustments. And all these governments lost the elections, to the point that the following governments, as I mentioned, do not want to take a risk of acting too early.

And, again, this is not an incentive which is typical of Europeans. I think if you look at the U.S. fiscal cliff issue, I think, also, the incentive for the politicians is to act at the last minute, so that they may not take the blame. And, ultimately, they can present the deal as the unavoidable deal -- or something which was the least worse of all.

Now this, as I said, is a dangerous strategy, because it's not necessarily the case that if you wait the last minute, and the only alternative is to jump into the precipice, into the disaster, that people will still want to turn their back and accept the austerity measures -- especially given the fact that these austerity measures have not necessarily worked in the past, in getting the economy out of the crisis.

So, there may be the temptation to look for new alternatives, new policies, new policy paradigms -- to follow those who may present some populistic temptation and solutions.

The problem is that, what's the alternative to these perverse vicious cycle -- the interaction between the politicians and the markets? What's the alternative?

Well, in theory, a good alternative would be to have a more gradual adjustment for countries, for instance, which have had excessive debts, excessive deficits -- to have a more gradual adjustment, in terms of reducing the deficit through time.

Now the problem is that governments don't have control over the time -- don't always have control over their time. It depends a lot on the credibility of the program, of the adjustment program in the eyes of financial markets. So, it depends on the financial markets' willingness to continue to finance the government for a longer time.

And what we know, in fact, from experience, is that financial markets don't act in a very linear way. Up to a point, they continue to finance imbalances, then something happens -- which is not necessarily always very concrete -- and they change their mind, and what was sustainable before becomes totally unsustainable.

And you can see this in the history of the European crisis.

Up until the spring of 2011, the Italian and Spanish deficit, for instance, was perfectly fine in the eyes of the markets. The spreads were lowered in 100 basis points. And then, in a couple of months, everything turned around, and the spreads spiked up to 500 or 600 basis points.

So, one of the known unknowns is the reaction of the financial markets -- is the way in which financial markets assess the sustainability of the debt.

Now given this known unknown, you would expect governments to be very cautious, and not to take for granted the way in which financial markets act. The problem is, instead, exactly the opposite -- that policymakers look at financial markets with the rear mirror. They consider that when financial markets are benign, everything is fine, and this situation will continue forever.

So, when the spreads come down, everything is fine, the problem is solved, the light is at the end of the tunnel, the recovery's around the corner -- all the good news are coming, simply because the spreads are coming down.

The problem is that precisely the reaction of governments to this benign market development is to start stopping the adjustments, stopping the reforms, start to be complacent. And it is exactly these reaction of the governments which, sooner or later, will induce in market

participants the thought that maybe what they expected was wrong, and the kind of convergence that they were expecting is not going to happen, so they will turn around.

The only problem is that, as I mentioned, this turnaround is very difficult to predict. And only when the turnaround comes, then the governments realized that what they thought was benign conditions and, you know, the situation was going to improve -- this was an illusion, and they have to start acting again, and the whole circle starts coming up.

And if you think about it, that's the whole history of the European crisis over the last three years. If you go back to September 2009, when the new Greek government got into power, they found out that the budget deficit was much higher than the previous government had said, for a series of reasons -- I will not come back to that.

But then the markets did not really react immediately. They were looking at how the government would -- what they would do as a reaction to this discovery. And the Greek government, looking at the markets, said, well -- they started to look, and discuss, and think how they would adjust. And the time was passing. Slowly, the spreads were going up -- until it became clear that it was too late; the gap was too high.

And at that point, of course, Greece had to go to the IMF and to the European partners to ask for help, and started with a huge fiscal

adjustment.

So, one, look backwards, the gradual adjustment in Greece should have been started earlier on, and should have been much more credible, and maybe we would have avoided some of the tough austerity program which had to be implemented under the pressure of the market, in May 2010.

Now, of course, the responsibility for acting too late was not only of the Greeks, because the other Europeans, also, were not looking at the Greek case with a lot of concern.

And, actually, if you go back even to March 2010 -- two months before Greece actually went into the program -- you can find some statements by the German Chancellor, by the Greek Prime Minister assessing, "Greece will never ask for aid. Greece doesn't need that. We can manage through a gradual adjustment."

And this, again, if you look at the Irish case, at the Portuguese -- I mean, all the cycles that you had -- the ups and downs between the spreads and the adjustment policies -- they reflect this interaction between markets and policymakers that I just mentioned earlier -- the Spanish and Italian bond spreads going up in the spring of 2011, up to a point where they were becoming, really, a problem for the whole euro area; then the ECB acted in exchange for a famous letter. The Italian got

leaked; the Spanish never got leaked -- but basically asking for the countries to do their own part in it.

But as soon as the ECB intervened, then the governments started really discussing many of the things, because they thought that the crisis was over.

So, that's the kind of problem with gradualism -- is that governments are not in control of themselves, of the time that they have to implement the gradual adjustment -- which would have been, certainly, a much preferred solution than the austerity.

So, gradualism is better, but it's not time-consistent for governments to act in a gradual way, because they tend to always start late in the adjustment.

I guess this is not only a characteristic of Europe; I think you could say the same -- I don't want to pick on the U.S., but Japan is exactly the same situation. Unless they have the pressure of the markets, the Japanese fiscal adjustment will just never take place. So, that's the first alternative.

The second alternative that is being discussed a lot -- in particular, in the IMF -- is, instead of implementing these tough austerity programs which, in the end, may turn out to be counterproductive, why don't we restructure the debt and have haircuts in the debt at an early

stage?

Now this is a whole discussion which is taking place -- which, in my view, doesn't take into account a couple of issues. One is that there are no real precedents of a debt restructuring in advanced countries. And we tend to think too much that advanced economies can be managed in the way in which emerging markets restructured debt in the 1980s.

And there's some fundamental differences. First is that, in the Latin American case, most of the debt was held abroad. So, restructuring the debt was mainly a problem of American banks, and how to avoid the impact on their capital, and how to avoid financial disruption.

The second difference is a contagion. In a monetary union like the euro, if a country restructures, then the immediate reaction of financial market is to look which other countries are going to do the same.

And third problem is, is it possible to restructure within the euro? Will the restructuring of the debt not create the exits from the area?

And, finally, given that a large part of the debt is held inside, when you restructure, you have wealth effects within the society -- starting from the financial system, which collapses. And then, often, it's poor people who hold the debt.

So, you have, you know, a haircut in the debts of parts of

society which are not necessarily going to accept it, politically.

So, the alternative of having an early restructuring of the debt was not available in the euro area -- also, because the euro area was constructed on the politics that there would be no crisis -- which is a simplistic assumption.

On the other hand, nobody expected to face the worst crisis since World War II, but it's true that, without a safety net to help those countries that were still solvent, a restructuring of a country would have led to domino effects. And that's why the discussion of restructuring only started after the completion of the European financial stability facility, which was transformed into the European stability mechanism.

So, now that we have a better architecture, maybe organizing a restructuring of a country which has an unsustainable debt is easier, but not necessarily that easy, because the contagion still can happen.

And we see that the Greek situation is still a delicate point for financial markets in order to assess the sustainability of the euro area.

The other issue, which is very difficult, is a whole concept of debt sustainability. When is a debt of a country sustainable? Well, you can have all your models -- which are based on assumptions about growth, about the reaction of adjustment processes -- but it depends a lot,

also, on the political will of governments to implement some of these things.

At the start of the Greek program, for instance, a large part of the financing was to take place through privatizations. But this didn't take into account the fact that a large part of the political establishment in Greece didn't want to privatize. And this is not only true in Greece, by the way -- it's throughout in Italy. If you talk about privatizations, there are oppositions to this.

So, the whole concept of debt sustainability is a complicated one. And, therefore, deciding whether to go through the austerity way or through debt structuring is not necessarily an easy choice to make, because both can have potentially very recessionary impact on the economy.

So, what's the alternative which is left, and the one on which we need to think more about? What is the way to gain some credibility in the fiscal adjustment process while having a slower or a more gradual adjustment?

And if I think about the case of Italy, for instance, in 2011, when the new government, the multi-government, got into power, and started implementing a series of measures to try to reduce the spreads -- and, of course, at that point, what was the easiest solution? It was to raise

taxes -- because, in the face of financial market pressure, when you are close to the precipice, you try to do something which is very quick, immediate -- raise taxes.

So, you think you're safe because you raise taxes, and the short-term impact may be that you bring down the deficits, that the markets come down. But, after a while, you have all these negative loops which come in, and the debt continues to grow.

So, when you face this situation, that you're close to the precipice, what can you do to gain time and to avoid the austerity, but, also, avoid a very costly restructuring?

Well, one of the issues that you have to realize as a policymaker is that the debt sustainability of your country doesn't depend on your deficit; depends, also, on the growth, on the denominator. And the growth rate depends on the competitiveness and the flexibility of your economy.

So, one of the key challenges for many European countries is how to improve and make more competitive their own economy.

So, the question is, is there a tradeoff between the more gradual approach to fiscal adjustments that's much more effective, much more frontloaded reforms of the economy, that make the debts more sustainable in the eyes of the markets?

And I think that's the key question we have to address. And I tend to believe, for instance, that if the multi-government in Italy had, at the end of 2011, presented two or three important reforms, the credibility of Italy -- the deficit was not that high; it was around four percent. But the real concern for the markets was the growth rate of Italy, which had been stagnating for years.

So, if you have the ability to reform the system and to change the way in which certain markets work -- such as the labor market or the goods market -- then you can regain credibility, and you can regain time to have a more gradual adjustment.

So, why is this strategy not followed? Well, it's not followed, because, in the end, for politicians to implement some structural reforms, it's, again, much tougher than to raise taxes.

And why is that? It's that many reforms think about the labor market's reform. You have to fight against the unions. You have to fight against the employees, the Entrepreneurs Association. In liberalization, you have to fight against lobby's interest groups.

So, the paradox in the European context -- and maybe not only in the European context -- is that, in the end, it's easier to wait for politicians. So, the political incentive is, it's easier to wait for the markets to put pressure on you and to raise taxes than to tackle fundamental

reforms -- because tackling fundamental reforms is politically very costly.

I think this is certainly the case in Italy. It's the case in Spain and in other countries. And I think it's the case, also, in Japan, for instance. We're all waiting for the third arrow in Japan of such reforms, and the fear is that it's not going to happen.

But in the end, the structural reforms are fundamental to increase the competitiveness of the economies in parts of Europe. And that's the only one. Even the German experience, earlier on -- they were fortunate enough not to have a global crisis, but they implemented structural reforms and gained more time to implement the fiscal adjustment. And this is what allowed the sick man of Europe to become the healthy woman of Europe, as Gerhard Schröder once said: You know, "I was the sick man of Europe, and now she is the healthy lady."

But, you know, it took some effort, and that's the way it worked.

So, the recipe -- which is to be more gradual and to gain time by having structural reform -- is politically very difficult to implement, and so you have to be forced to do that. And there is a technology -- which is to commit yourself to that. For instance, through IMF program -- I think that's what is happening in Greece; slowly, in Ireland.

So, these structure reforms are happening, but it takes time,

and it takes financing, and the markets take time to get convinced that this is working.

So, this is the dilemma in many European countries. Unless they are able to implement the reforms, they will end up with the worst policy, which is austerity, which is raising taxes at the last minute. And this creates all the negative reactions and the negative incentives that I mentioned before.

The last observation in all of these problems of incentives for policymakers -- there is a key actor which has come out of the crisis, not only in Europe but all over the world -- is the Central Bank.

Why? Because the Central Bank can take away the pressure from politicians -- the pressure that the markets are exerting on politicians -- by intervening directly in the financial markets.

And we have seen that all over the world. We have seen that in the U.S., in Japan, in the euro area, and it's right for the Central Bank to do so, because the markets, as I said, tend to overreact. So, you need to give time for the policies to be implemented, for the structural reforms to be activated. And the Central Bank has this power.

The only problem is that if it chooses too much of this power, again, it takes away the incentives from the politicians to act. And, unfortunately, we have seen this again and again in the euro area. I

mentioned earlier the case of 2011, with Italy and Spain. The 2012, a similar situation arose again, where, with the OMT, the announcement that ECB would take away the catastrophic risk -- or the tail risk of euro disruption has led to a reduction in the spreads.

And if you look at the reform agenda after this event, where the reform agenda was delayed even more -- and this is true, also, for the European reform agenda, which is building up the remaining institutional pillars of the euro area -- and, again, this is not only a European phenomena. If you look at the U.S., if you look at Japan -- when the Central Bank acts, intervenes in the markets to give the politicians time, the politicians will use this time more and more, and will want more of this time.

So, in Europe, we have a very similar problem to the one that arises in other parts of the world. The only thing is that it's more complicated in Europe, because you have 17 governments, and the way in which the Central Bank can exert influence on each of these countries is by intervening directly into their markets, which can be very distortionary, in one way or in the other. But if it doesn't, the risk is a collapse of the euro area.

So, the ECB has this tradeoff. Should it intervene? Should it not? How much for how long? How much time should we give to the

politicians? I think that's the broader question for all our advanced economies, where tough decisions have to be taken because the growth potential of our economies has been eroded – the reason is to need to regain competitiveness, and this regaining of competitiveness cannot be achieved through moderate policy; it requires more fundamental changes.

And these changes are tough, are difficult, and politicians don't want to face tough decisions until they are forced to. But then, when they are forced to, they tend to take the wrong decision. And this is a dilemma. It means they tend to go for the austerity.

So, that's the risk for our society, I think, and it is challenging, because it may lead to, at a certain point, centrifugal forces, and lead, you know, to rises of political forces -- and you are already seeing this in many European countries. It may say there is a better way out -- and it's not true that this way out is that problematic. In fact, it will lead you to a better world, because if you get back your own national currency or if you default on the debt, then all the problems are solved.

And the risk is that people will listen to these voices, because the voices of the more traditional politicians have lost credibility. So, that's the big challenge, I think, for our society.

I would stop here, maybe, and look forward to your questions.

MR. SHAPIRO: Thanks, Lorenzo.

So, Doug, I guess Lorenzo has described almost a tragic, almost Shakespearian interaction between democratic politics, and markets, and the incomplete monetary union.

Do you see it that way, or do you have a different view?

MR. ELLIOT: I partly see it that way, and partly have some differences. So, I will expand at length upon that.

I will say it's possible to read his excellent book and become very depressed, just as you imply. I guess I'm more upbeat than that, and I think probably Lorenzo is, too, in the grand scheme of things. But I'll let him come back to that later, if he wants.

First of all, thank you. This is an excellent book -- and of course I'd say that; I'm sitting up here next to Lorenzo. But it really is an excellent book. I do recommend. It's very well thought through. It's very muscular, in a sense. There's very little fat in it, and it's very clearly written. So, if you have not read it, do so.

He starts, basically -- and much of the book continues in this trend of trying to put the euro crisis in a global perspective.

So, part of his argumentation is that many of the problems facing Europe in this crisis are common to all of us -- or at least the advanced nations. In particular, he tends to point out the problems of

demographic change that we're aware of -- the aging of the advanced economies -- and issues revolving the adjustment to globalization.

I don't think Lorenzo is trying to say globalization is a bad thing, but it creates the need for many adjustments. And if you don't make those adjustments as a country, then you end up suffering -- and will eventually have to make some form of adjustment.

The proper solutions he indicates are very often thwarted by political tendencies to postpone pain, and to accept incomplete solutions. So, as he said, you push off the painful restructuring until you hit the point where you have to do something, then you grab onto something you can do quickly.

And in Europe, that something you can do quickly has very often been austerity in the form of tax increases. Bill may have an interesting perspective on this. I'm not confident that the easiest solution in the U.S. politically would be to raise taxes in an equivalent situation. But in Europe, it is.

And it does have the advantage that, if your tax-slashing system is reasonably good, in the short run, you can be fairly confident you'll get the extra money, and reduce your deficit.

As has been indicated, there are then other problems you create for your economy by doing it that way -- and that comes back to

haunt you, and may reduce your medium and long-term tax intake. But in the short run, it's a quick fix.

Throughout all this, Lorenzo emphasizes the short-term focus of politicians. And, frankly, I think we'd agree, almost all humans have a short-term focus.

So, one of the things he comes back to later in his solutions chapter is to talk about ways in which we can build institutions to try to create pressures to avoid giving into those short-term temptations.

Now one of the short and medium-term temptations that I think he spends the most time on and some of the most fervor -- given that he's a former central banker, it makes sense -- is, central banks, like our Fed or the European Central Bank, are in a position to basically take most of the pain away for a period of time.

And that can be the right thing to do. I mean, I, for example, have broadly supported the quantitative easing that we've seen.

But it's possible to use it in the wrong way, where it becomes a drug. It dulls the economic pain. It allows you to avoid the tough things. But since you then don't do what you have to do, the day of reckoning comes again, and you either take a bigger dose of the drug, or you finally face the need to do something.

So, he puts this in a global context, and it makes sense that

his initial thought had been, how could he explain this to Americans who aren't as familiar with what's happening in Europe, and put it in a context where we might understand it? And for that, it's, of course, helpful to put it in a global context, where we, too, have seen similar problems.

He also, though, acknowledges appropriately that Europe has a set of specific institutional problems due to the fact that it's both one union and many separate states, with much greater differences between them than we have between the states in the United States, for example.

And he's also appropriately reminding us, the U.S. took a couple hundred years to get to where we are now. Something I like to remind people -- because not everybody paid that much attention in history class -- we're on our second Constitution, not the first. We had the Articles of Confederacy, which we had for maybe five years. It didn't work.

So, the fact that Europe is trying to come to constitutional arrangements that will let it have a sound future, and it's struggling, is certainly not unique to them.

And, of course, many other countries have gone through constitution after constitution. So, it's just important to remember all that.

I probably won't dwell as much on the Europe-specific issues; their institutional arrangements. But they do create a lot of difficulties and a lot of risks. So, I'll come back to them from time to time.

So, the core of the book takes these broad issues that I've just described, and goes through, chapter by chapter, key points in time in the euro crisis and the major issues that were being faced, and shows how they were framed by these problems and constraints that he's laid out at the beginning.

He only gets to answers at the end, and, even then, they're only quite partial answers, as I'm sure he himself would admit.

So, the great bulk of the book is showing how the problems he's described play out in terms of creating much greater pain than was theoretically necessary.

Another point that he's emphasized that I would like to, as well, is, financial markets have played a very important role in the euro crisis, because they've been the main source of direct pressure on the governments of Europe.

And we're setting ourselves up for the same situation, conceivably. Basically, if you, as an individual or a country, borrow a lot of money, at a certain point, you have to care about the opinions of the people who lent you the money.

And so the markets have been a key mechanism for kind of having a vote of confidence or no confidence in the economic policies and the political policies of the countries in Europe.

And I'm really hoping Bill will tell us we're not going to get in the same situation ourselves later, but we'll see. I'll leave that to him to discuss.

But one of the things that makes it hard -- as Lorenzo's noted -- is, the market responses are nonlinear. Basically, the market tends to react by assuming things will work out -- until they get to a point where they get quite scared they won't. And then things can move very dramatically.

So, one of the reasons that's particularly difficult is, governments -- and, I would argue, especially European governments -- don't tend to understand the markets very well -- at least the financial markets -- nor, by the way, do financial markets understand the governments all that well many times.

And so you can get -- well, the same kind of problem we've been having with the Fed talk about tapering. Recently, you've seen in the U.S. that one of our government, the Fed, has been trying to move things in a certain direction. The markets misunderstood sometimes; the Fed has misunderstood them sometimes, and it's been a bit of an unholy mess the last few months.

But going back to Lorenzo's book -- and Europe, in particular -- he emphasizes that the crisis response has ended up, for all the

reasons he's described, as having too much in the way of austerity, and too little in the way of structural reform. And I think it'd be hard to argue against that.

But this leads to bad political outcomes and bad economic outcomes. So, many of the solutions are focused on trying to rebalance the reactions so that politicians do more on the structural side, and don't have to impose so much austerity.

There's a great deal here to agree with -- and that I do agree with. I'd say I'm sympathetic and in general agreement with the great bulk of the arguments of the book, to answer your much earlier question.

But there are some nuances and even outright differences I would like to focus on. First, I personally suspect that the problems are a bit more specific to Europe than the book implies -- in degree, if not in kind. I think the general issues he's pointed out are true for us, and Japan, and other places, as well.

But I think the severity of many of those problems have been worse in Europe -- and, of course, magnified by their kind of transitional political structure, where they're in this odd mix of being a single place and not being a single place at all.

And what I'm about to say, I wouldn't be surprised if Bill disagrees with, but I think that, despite all of our many flaws here, I believe

the U.S. political system is better able to handle the medium and long-term problems we face with the demographic and globalization changes than is implied by Lorenzo's book.

Now, again, this may partially be an artifact of him writing this with the thought of, "Let's help Americans, in particular, understand why Europe is reacting the way it is." It may have led to an overemphasis on parallels and insufficient emphasis on differences.

I think he also gives a little bit too much of a free pass to the leadership in Europe. He pretty much outright says that we shouldn't be too harsh on the European leaders; they're operating within a set of constraints that are really very tough.

And, at one level, I agree with him. But I think if you look at the great European leaders of 20, 30 years ago, they were often working under very difficult constraints, as well, and yet, they would step forward sometimes and propose fairly dramatic solutions. And then they would bring their people along with them.

Now I have no clue, personally, how to be a great leader. I'm not trying to say it's easy, but I do think it's notable that I don't think we can name someone in Europe right now for whom that fits. Chancellor Merkel's done an excellent job in many ways, but she's done a very cautious job -- not the type of leadership that I'm describing.

Similarly, since I'm dispensing blame so freely, I think the book lets the central banks -- particularly the ECB -- off a little light, as well. And that would make some sense, coming from his orientation.

But I believe that -- by the way, I think think-tankers were totally not responsible for any problems in the world, just to be clear -- but I personally, along with many Americans, believe the ECB waited too long to take easing actions -- and, in fact, for a brief period, were tightening when most of us on the other side of Atlantic thought they should already have been easing. There's not a lot of discussion on that.

And, again, from an American perspective, the ECB seems to have a little too singular of focus on inflation. Now that's their formal mandate. So, at one level, you have to be careful about blaming them for that. But nonetheless, regardless of formal mandate, institutions operate in ways that can try to achieve more than one objective at the same time. And I think the ECB could potentially have done more in that regard.

Having said that, a point he emphasizes that I absolutely agree with is, there's a huge -- what economists call moral hazard issue here -- and that's basically the one. If you help somebody out of their money problems, as the ECB has, to some extent, and the Fed has over here -- if you help them get through, they may not change the behaviors that have created the problem in the first place.

And I think he was too polite to directly reference this, so he came close -- what happened in Italy was, the ECB eased -- and I think that was 2011 -- the Italians said, "Thank you very much," put off their structural reform plan, and the ECB felt it had to come back so hard that they're perceived as basically knocking Berlusconi out of power.

You do definitely have this issue. As soon as things ease a little bit, then you have to worry that people won't do what they need to do.

All right. Let me get to the solutions -- and "solutions" may be too grand a claim for it -- and I don't think necessarily that Lorenzo even says they're solutions -- but what he said was, "There's some issues to think about as we design the right solutions."

First, he argues that there is distinctly a need to reform the welfare systems in Europe -- that they're too generous at this point. And I think a lot of that has to do with the old-age pensions and things that touch on the demographic problem.

He talks about -- and this is an issue that seems to be bigger in Europe than here -- the need for the media to be independent from the elites. Now I know there are people who claim, you know, the major U.S. publications are captured by the thought process of the elite. I wish they were, but, in Europe, you have things like Silvio Berlusconi owning half of the major broadcast systems -- and other issues of that nature.

So, I found it interesting that this was one of the points emphasized. I would certainly agree with it.

He argues that we need to have more independence for the people who come up with the government's growth and budget forecasts, more independence for central banks -- not a surprising argument from Lorenzo -- argues that it may be useful to have constitutional debt or deficit constraints.

And a point I certainly agree with him on -- he argues that wider European institutions need greater democratic legitimacy. He says giving more power to the European Parliament is what will probably have to be a key part of that.

I partially agree. On the other hand, I think the European Parliament, after 2014, is going to have a big chunk of populace who will have attitudes that I think are destructive to Europe. So, it's going to be hard to figure out how to have that balancing act.

So, just to wrap up, let me say -- the book is extremely well-written. It does a brilliant job of explaining the euro crisis and putting in the larger global context, and really showing kind of the workings of the economy and the political structures very clearly.

And by the way, I get no commission from the book, but I do urge you, again, to buy it.

MR. SHAPIRO: Thanks, Doug.

So, Bill, this problem of politicians delaying decisions until a crisis is imminent is one that we've long since solved in the United States, I guess, and so --

MR. GALSTON: Absolutely, yeah.

MR. SHAPIRO: Yeah. So, what can we teach the Europeans about any of this?

MR. GALSTON: Well, if things go badly the next six weeks, we can teach them how to bring down the world financial system.

But let me just ask you -- what time is it? My watch broke, and I'd --

MR. SHAPIRO: So, it's 7:00 now. So, if you could just do five for five minutes.

MR. GALSTON: It's 7:00. That's what I was afraid of.

MR. SHAPIRO: Yeah, we're a little behind.

MR. GALSTON: Okay. Well, given the fact that, you know, I have only a layman's knowledge of Europe -- less than a layman's knowledge of financial markets -- and I am not now nor have I ever been an economist -- it seems to me that my value-added as a political scientist is to reflect on some of the political economy dimensions of what we've talked about, and to inject some brief comparisons between Europe and

the U.S.

And I agree with Doug that the dis-analogies are as striking as the analogies. You know, so I'm going to look at the basic structural building blocks of the argument, rather than the particulars.

You know, I absolutely agree with the first step that Dr. Smaghi takes -- and that is, the fiscal crisis has to be understood as a symptom of deeper economic problems. I think that is absolutely correct, and if we don't start there, we're not going to get very far.

One of those deeper problems is globalization. It's exerting severe pressure on the European social model -- in part because of labor market and other rigidities that are built into that model.

Well, no one can accuse the United States of having a rigid labor market. If anything, our labor market is too flexible. But that is generating problems of its own for the United States. You know, we've had, you know, a sustained period of wage stagnation. Medium household incomes are no higher than they were in 1989. The middle class is shrinking as a share of the total population.

And so, you know, both the United States and Europe are in the globalization boat -- although we're rowing somewhat different oars.

Demography -- another big driver -- we are an aging society, but nothing like Europe, let alone Japan or China. Our fertility rate is

slightly below replacement, but not dramatically. You know, we have a history of relatively generous immigration that largely compensates for that. So, I don't think demography is a problem for the United States on the same scale.

But there are the problems of democracy as such. And here, the United States rejoins Europe, because in periods of financial crisis, the best course of action is bound, for all of the reasons Dr. Smaghi has stated, to be a very unpopular course of action.

The name Gerhard Schröder has come up more than once in this conversation. As I recall, his political career died for Germany's sins. And relatively few politicians are in the business of self-immolation -- at least knowing self-immolation. Many of them end up immolating themselves, you know, for other reasons.

You know, one of the democratic problems -- problems endemic to democracy -- well, you know, the logic of democracy and of maintaining popularity generates all sorts of perverse incentives. If I had more time, I'd go through them. There's a very interesting catalog of perversity that can be constructed out of the different observations that Dr. Smaghi makes in his book.

But one of the deepest problems is that democratic bells, once rung, are very difficult to un-ring. Promises once made and

integrated into the fabric of programs -- and then society -- are very hard to reverse or modify. Behavioral economics teaches us that the hardest thing of all is to take away something that people already have; much easier not to give it to them in the first place.

But when times are good, the temptation is to give people the things they want -- but it's very sticky on the downside. It's easy on the upside; sticky on the downside.

There is -- and here is a final area of dis-analogy -- I'd say, a broader institutional, you know, difference between the United States and Europe. You know, European integration is clearly incomplete. I don't think anyone would accuse the United States of being incompletely integrated at the political level right now. If anything, it may be a little bit too integrated.

You know, the comparable problem in the United States is not lack of integration, but it's political hyperpolarization -- which is yielding the typically American form of combination of gridlock and populist outbursts.

Another important dis-analogy is that, unfortunately, external pressures don't have the same effects on the United States as they do in -- you know, as long as our currency is in its unique position, then the sorts of external pressures that have driven some European countries to act, I

think, are going to be much more attenuated in the American case. And that is a problem, you know.

And it's a problem that's going to lead to bigger problems, because very low interest rates have facilitated the accumulation of public debt at historically low interest rates.

Well, historically -- I went back and checked this -- the average interest rate on U.S. debt is about four percent. Well, basic math tells you that early in the next decade, we're going to be spending upwards of a trillion dollars on interest payment on the U.S. debt alone, if interest rates return to normal. And if they don't, that will be a symptom of such a terribly prolonged economic downturn that we're going to be in even a bigger mess.

Final political economy point -- you know, Dr. Smaghi, you know, in sync with a lot of other thoughtful Europeans, you know, says that the solution to the problem of Europe is more Europe, okay -- that Europe, you know, takes its own path from the equivalent of the U.S. Articles of Confederation to the U.S. Constitution.

I think it's going to be much harder for Europe to take that step than it was in the American case -- for all sorts of reasons. And if I had more time, I'd go through them.

And so what if more Europe, in the end, is not a realistic

political possibility -- as I believe it is not? Then what?

MR. SHAPIRO: Okay -- some easy questions.

I'd like to actually just add on a little bit to that, and ask you to prophet a little bit from your experience at the European Central Bank to reflect on the slightly more specific question that goes along with Bill's, about the future of the European Central Bank.

I think you implied that the European Central Bank gained a lot -- or at least exercised a lot -- of power in the course of this crisis that nobody really designed into it. And do you expect that that will continue, or are you worried that there will be a backlash against that, either at the popular level or at the governmental level? And how will that affect the future of the European Central Bank and its ability to play this role in the future?

DR. SMAGHI: Okay. Thanks, first, to all these comments. I'll try to address a few issues.

Let me -- I was very critical with the politicians, with the policymakers. But I think the statement I should have made before is that it's much more difficult to be an elected politician today in advanced economies -- U.S. or Europe -- than it was 40 years ago, when growth was there, and the task of politicians was how to redistribute growth.

Here, I think -- and from that point of view, I think the U.S.

has, in my view, a learning gap, compared to Europe. I think the next years won't necessarily be better than the previous years -- in the sense that the challenges of technology, globalization, aging will lead to a lower growth potential. And that's what we observe -- growth potential has been revised systematically.

So, the task of politicians today is tougher, because they have to take decisions, which have to be consistent with lower rate of accumulation of wealth -- and eventually, for some parts of our society, even a decrease in wealth. And I think, as you mentioned, the middle class in the U.S. is decreasing, and this is true, also, in Europe.

So, they are tough decisions. I mean, policymakers today have to take much tougher decisions than many years ago, and they don't want to do that.

And, of course, they are short-term, I think, in the U.S., also, because you have elections every two years. So, the short-term miasma of policymakers has increased, and this is a problem, I think, for all our societies.

Now I agree that the U.S. has a decision technology which is much more efficient. Let me take one example -- the way in which the banking crisis was dealt in 2008. But if you remember well, Paulson was able to convince the Congress to vote TARP because Lehman Brothers

collapsed -- and the stock market went down -- I don't know -- 30 percent.

So, in the middle of a financial crisis, the U.S. Congress decided, "Maybe we need to stop that." They voted for TARP, and many of those who voted for TARP were voted out of office by the people. And I think it would be very, very difficult to have a TARP voted again in the U.S. You would need, probably, an even bigger financial crisis.

Why? Because the people in Europe and in the U.S. don't want to give money to the banks.

MR. GALSTON: Well, we're doing our best to generate that (inaudible).

DR. SMAGHI: So, this perverse mechanism, even for the more efficient parts of our Western world, gets tested very strongly by these -- and, of course, Europe learned, I think, from the U.S., and the move to a banking union with a single supervisor is a way to try to get more effective. So, the U.S. is, to some extent, a model for those parts that I think they manage much more efficiently -- even though they needed a crisis to do what the U.S. done.

So, I agree with you that the U.S. is still ahead, in terms of technology of solving problems, but this technology's getting weaker and weaker, also, in the U.S.

I agree with you that maybe I was too soft on the ECB; that

we may have made our own mistakes. I think, you know, compared to the Fed, I don't know who made more mistakes, but I would not want to enter this type of debates here in Washington -- because you have to look at the mistakes, also, before the crisis, that fueled the crisis.

But going back to the difficulty of policymakers -- we are used to addressing the problems in macro terms, by borrowing from the future. So, we borrow, we spend, and our children will reimburse the debt.

Now this is great, first, when the number of children increases, and, second, when the world will be better tomorrow than today.

In the kind of world in which we may turn out to be -- in which the world tomorrow is going to be even tougher than today -- borrowing from the future will make the future even worse.

And I'm not sure that these kind of issues are discussed here in the U.S., as they should. And, certainly, in Europe, they are not -- or they are, to the extent that there are many rigidities in the functioning of the markets and so forth, which make it very inefficient to try to borrow from the future, if the future is going to be -- and monetary policy is a way to do that, like fiscal policy.

So, if you have low interest rates for a long time, it means that the future will pay for you. You are trying to keep asset prices higher

today to boost consumption, but the adjustment will take place tomorrow.

And we saw this with tapering, right? As soon as the Fed start in discussing tapering, asset prices collapsed. Now there's no tapering, so, boom, it's fantastic again. But the adjustment will take place tomorrow.

And this is okay, as long as tomorrow is better than today. And this hope is not necessarily going to materialize, if the kind of crisis that we experience is a structural crisis.

And I agree -- so Europe has to complete. And some more Europe is needed, in the sense that we need a single financial system, a single supervisor. We need some adjustment mechanism -- shocker absorbers, like you have in the U.S.

I don't think we need a single school system like you have in the U.S. People will not accept that. Probably, we don't need a single labor market like you have in the U.S. -- although we may get there.

But I think there are many resistance to have Europe looking like a single country. Actually, people want to bring back some of the powers closer to them, which is, maybe, something which is going to happen in the U.S., also.

But I agree with you. The analogy between U.S. and Europe should not be pushed to the extreme of saying Europe should look like the

U.S., because it's not looking today, and it's not going to look tomorrow. But we have to take from the U.S. and the experience of the U.S. what is useful, and what the U.S. have done better than Europe. In that sense, moving to a banking union is very important.

And through that, we may have, in the European Parliament, many anti-Europeans. But I would say that may be a good thing, because -- so European Parliament and Europe, they will have to talk about centrifugal forces. So, they will have to deal -- instead of these forces being expressed only at the local level.

So, I would actually want some of these anti-Europeans to be in Europe, and debate with the others, so that this issue becomes a European issue, and not only a national issue.

Maybe I didn't address all the issues. The media independence is very important -- not only media, but European media, which is very difficult. In the U.S., you have a chance to have national-wide media. We have local media, because all countries have their own media. So, it's very easy for the German media to depict the Greek as lazy, and for the Greeks to depict the Germans as all Nazis. It's stupid. It doesn't help, but it sells a lot of copies.

I was told by a seriously trained journalist that every time they have a title against Merkel, they sell more copies -- because it

creates an enemy, it creates, you know, somebody to blame for the problems that have been created by Italians, not by Germans.

Finally, on the future of the ECB -- one of the problems that we had in the Central Bank is to find out that we were too powerful, and we were alone. And some of the problems we were attacking should have been tackled by the political authorities.

And I think it's a trap in which many central bankers are going to find themselves. I'm thinking about Japan. When the other arrows will not be thrown, what will Kuroda do? He said, "I did my part, and what about you?"

And I'm afraid this will happen to the new Fed President -- we say, you know, "We did all this, and, you know, you didn't do your part."

And our experience was, we are avoiding crisis, we are doing our thing, but you have to decide. You have to now create the assent.

And, unfortunately, we were able to put pressure on them by taking back the pressure of the markets, because the politicians react only when the markets put pressure on them. And it's a very inefficient system, very inefficient.

But what is the alternative for an independent central bank?

It's not that clear, because pushing more money, more money is just going to induce politicians to postpone.

So, the central banks have become political actor, and it's very dangerous for their own independence. That's my concern, I would say.

MR. SHAPIRO: Thanks. Well, I think we learned from this panel that the problem with democracy is the people.

So, in that vein, we have left very little time for questions. But I'll take one round of a couple of questions -- in the green, right there. We have a microphone coming down here.

MR. HARRIETT: All right. Thank you. Judd Harriett, documentary filmmaker.

One thing that hasn't been discussed has been demand management policies to arrest the sliding growth after the financial crisis hit. Would this have been possible within the context of the E.U.? And if it was possible, how would it be implemented?

MR. SHAPIRO: Let's take a second question -- in the middle there.

MR. PRIVITERA: Yes, Alex Privitera with AICGS.

My question goes to the core of what Mr. Bini Smaghi just said. It's a question of moral hazard, and how can you overcome this

problem if the mechanism is as you described it? Would, for instance, a replacement of market pressure through peer pressure -- you know, by peer pressure -- be helpful in that context to allow a more gradual fiscal adjustment, but more peer pressure in the context of Europe from other Europeans or European institutions towards certain member countries, to actually be more serious about structural reforms? Or is that a wild goose chase?

MR. SHAPIRO: So, why don't you just take a couple minutes on those two questions, and then we'll have to wrap up?

DR. BINI SMAGHI: Yep. Maybe there's the second question first.

Peer pressure is key, but what we find out during the crisis -- that, you know, politicians don't like to be nasty to each other. They like to be friendly around the table. Only when you have a major crisis, you want to confront each other. So, only when there is an existential issue and the euro is at stake -- then they put pressure on each other.

But otherwise, they would like somebody else -- like the IMF, maybe, or the Commission -- to put pressure.

So, that's certainly an avenue. I think the IMF should work much more on these conditionality, on structural reforms, and so forth.

MR. PRIVITERA: I'm thinking of the competitiveness

contracts that's being floated (inaudible).

DR. BINI SMAGHI: Yeah. So, that's one issue, but it's -- you know, again, it's a contractual arrangement; it's not an institutional arrangement.

And I think this is one way to go, because it's very inefficient to have the markets doing the job. But, ultimately, it's not easy to devise institutional instruments that force countries to be competitive.

I think this crisis will help create a culture of competitiveness in Europe which was not there -- and I think you need a crisis to, because the start of the euro was just, you know, we are in heaven, and they didn't realize that, you know, this doesn't work; you're not in heaven. You cannot earn more than you produce; otherwise, you get into a crisis.

On the demand management policy -- I mean, that's a very important issue, because there's no European government, there's no European debt. So, management of demand is delegated at the local level. And, clearly, if you start a crisis with too high of debt, you don't have space for demand management.

So, some countries had space; others did not. And the problem is that those who did not have the space were those more in need of demand management. But they couldn't do it, so I think that's another lesson that, in good times, you have to start reducing your debt so

as to find the space in bad times. And some countries were not in a positive situation, because they didn't save enough in good times.

But the issue of demand management in Europe is much more problematic than it is in the U.S. On the other, we won't have a euro bond or a European fiscal authority for quite some time.

MR. SHAPIRO: Okay, thank you. I apologize for the lack of populism in my moderation, but I think we're going to have to wrap it up there because our speaker has to go.

Please join me in giving a hand, both to Lorenzo, and to panelists.

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