Modern Money Network, The “Money Series” 2012-2013

3. DESIGN DEFECTS AND POLICY FAILURES: *AN INSTITUTIONAL ANALYSIS OF THE EUROZONE CRISIS*

[Rohan Grey] [0:00] Good everning and welcome. My name is Rohan Grey, and I am a Columbia law school student and I am the organizer of this series. Thank you very much for everyone who makes it out on a Friday evening. Appreciate you taking the time and hopefully we won't be here for too late so that you can go out afterwards. I won't speak very long apart from saying that this is the 3rd event in eight part series going on here in the law school evaluating different issues currently affecting global monetary system in the global economy. We really encourage you to look at the material we have online, look at all the other events and if you can't make it to a particular event, then there will be life streamed and videos will be posted afterwards. Please stay involved and please keep asking questions online afterwards. Without further due, I will introduce Professor Ugeux to introduce the speakers and stuff of the seminar.

[Ugeux] Thank you very much and congratulations. I have been _____ by having a class at 1:20 on Friday afternoon at the law school which proves wrong but having this crowd at 6:30 at this event. Whether I will try to make it as close and as instructive as possible. They have been …. as the title says some designs defects and some policy failures. And so..that's going to be the focus about the Euro zone Crisis although I am sure that we will go into a few other things.[**1:30]**

Just to put things in "______perspective???" in December 2009 when we discover the amplitude of the numbers of the Greek Deficit and "indepthness??" which supposedly wasn't known by Euro's Debt before. Mrs. Merkins says that this is not a problem for Europe, this is not the problem for Euro, this is the problem for Greece. Almost 3 years after...Yesterday Mario Draghi the President of the European Central Bank was still arguing whether he was prepared to take some losses on the Greek bonds that eventually he bought in the 2008-2009 period...the ECB balance sheet blew up from 500 to 3 trillion Euros and it's well on its way to get to 4 if they do what they say they would do which is to buy Spanish and Italian bonds which by the way they haven't started doing. My ______ is that they will do so which is true but nobody knows how much, nobody knows when.. but a little bit of optimism _______. To discuss that, I am going first to introduce Marshall Auerback.....sorry.....Yaniss Varoufakis, He's a professor of Economics. **[2:57]** He teaches Economics Theory at the University of Athens and Visiting Professor at the Lyndon B. Johnson Graduate School of Public Affairs at the University of Texas, and He is also an In-House Economist with Valve Software. I'm sure he will talk to you about that. But more interestingly.... basically....he is guilty. Because he was advising the President and the Prime Minister of Greece, George Papandreou until 2007 and the crisis happened just after he left. So he has not only the theoretical view but also he's been in the trenches of the Greek situation, and I am sure that what he has to tell us is going to be totally fascinating so Yanis.. Sorry for missing your first "step???" and we are very happy that you are here and very interested in listening to your part of the story.

[Yanis] Thank you everyone. Thank you George for the introduction. Yes, I am guilty as charged. My only defense is that after I stopped advising George Papandreou, firstly he won the election which he hadn't done when I was advising him. Secondly after he won the election, I turned into another critics of his government. Greece is not important enough to be occuping the headlines around the world for 3 years. **[4:30]** Imagine a situation where a crisis in the state of Delaware was threatening to bring the United States of America down. If that happen, the problem would not be the Delaware. It would have been within the United States of America. Let be not beat around the bush ladies and gentlemen, the Euro zone is disintegrating and I shall just call upon the exhibit A without B or C to follow. One Euro in a Greek Bank account has a much lower present value ... expected value than one Euro in an Italian account. And the Euro in an Italian account has a lower expected value than a Euro in a Parisian account which has a lower present value than a Euro in a German bank account. In Nevada.. which is from what I hear… badly hit by the 2008 Crisis, one dollar in a Nevada bank account is exactly the same present value in one dollar in a New York State bank account. And that tell the story.

Now... hindsight is not a very good guide to the truth. Most of my Anglo-saxan friends, colleagues, academics, journalists…. utilizing the benefits of hindsight turned around and say to me... "What did you expect? **[6:00]** You Europeans have the audacity of buying things together as economists as one currency Union. Did you expect it to work?". Well... it didn't work. But that's not because it could not have worked. Come to think of it. Take the United States of America again. It is a Union of very desperate economies. The economy of Missouri and the economy of Califonia are just as different as the economy of Portugal and the economy of France or Germany. Indeed, within Germany, before the

Euro zone was created and after, you will find that there are many regions that are totally at odds with one another. Bavaria and the Eastern states of Germany, for instance, different economies, different vitalities, different degress of capital accumulation. To put it differently, every country every currency union because the United States is a currency union, Britain is a currency Union indeed Germany was a currency union before the Euro...comprises surplus regions and deficit regions. Take the United Kingdom for instance. Yorkshire is always going to be in deficit to London, and Wales is always going to be in deficit vis-à-vis England. And yet these currency unions do not give rise to crises **[7.30]** which lead the English to saying that welsh might be thrown out of the United Kingdom or the people of Missouri will have to pack up their bags and leave the United States of America. Now there are of course political institutions and cultural reasons why that doesn't happen. But the reason why we have a very different situation in the Euro zone is completely utterly economic, and it has to do with the way we create and close to the problem that we have in Europe now can be solved quite profitably in the 1920s. Because the 1920s were typified by common currency of that era. It was the gold standard. The gold standard is significant in this context is that it bound together different currencies and fixed the exchange rate with gold and with one another, creating effectively a single currency. It could be of course .... it was of course the French had the Franc, the German had the mark, the Americans had the dollar and yet these will lock into one another and in a fixed way and vis-à-vis gold. So effectively the capitalist world in the 1920s was operating as if under the same currency.

The end of the 1920s.... so the crash of 1929 and the financial explosion which began in Wall Street.. and **[9:00]** what was the first thing happened? The first thing that happened was infection of the main street..from wall street and a very quick disintegration of the common currency of the gold standard. It was indeed Roosevelt's great move the first thing he did to get the United States out of the gold standard and follow Britain down that road, and the country that didn't do it was hanging on for the dear life and the gold standard was Holland and it has the worst impact of the Great Depression. The lesson from this is part of our common history is that if you try to create a common currency, a fixed exchange regime more or less the same thing from the economic point of view...and you lack a way of balancing or recycling as I'd like to say the deficits of the deficit regions with the surplus of the surplus regions. Then those regions are going to start shifting under the weight of the surpluses and the deficits that increase like the tectonic plates eventually that we create the circumstances from an earthquake like they did in 1929.

In the United States of America, there is a common currency binding the different states together but there is also a surplus recycling mechanism actually various **[10:30]** suplus recycling mechanisms. Let me just give you a couple of examples. I could give a lot more. When in 2008, we had the crash here in New York, Wallstreet... immediately the state of Nevada faced a major recession which has to do with the bursting of the bubble of the real state. Imagine what would have happen if the State of Nevada has (allowed the bank to domicide in Nevada????). And also, if the State of Nevada has to borrow internationally without access to printing presses in order to pay for employment benefits for a population whose employment rate was skyrocketing. What would happen in this? The banks of Nevada and the State of Nevada would have sunk without a trace hugging each other like two very weak swimmers in stormy water. This is what's happening in the

Euro zone. The fact that the taxes in New York and in Califonia that help ameliorate the problem of paying employment benefits in Nevada is a form of surplus of recycling. Let me give you a second example because I promised two.

When Boeing gets a contract from the pentagon to build a new fighter jet or whatever….drones...I don't know what....one of the conditions for that contract is that new production facilities are going to be built in Minnesota, in Missouri, in Tennessee, in Arizona **[12:00]** in the deficit regions. This is not an act of philanthropy on the part of the Pentagon to the deficit regions of the United States. It's just pragmatic economics because only by building a production facility in a deficit state do you create in the deficit state a flow of income... people get jobs.. start working... they are not getting benefits....they are getting income from productive activities...and then they can keep buying goods and services from California from New York.. states from the surplus countries...states...to maintain the flow of economic activity that allows California to maintain surpluses vis-à-vis Arizona. So as California is always going to have a surplus is-à-vis Arizona. So these surplus recycling mechanism such varies mechanisms are essential for keeping the union going. So..to my Anglo-Saxon particularly British Euro-skeptic friends..I say....the fact that we brought together disparate Europe countries under the same currency is not the problem per se. The problem is that we did it in a gold standard fashion without a surplus recycling mechanism hoping that it would float.

After the war, the United States of America emerged as the only serious surplus producing country **[13:30]** following the human catastrophe of the Second World War in Europe in Japan everywhere. In the Bretton Wood conference, Britain and the United States particularly had agreed on one thing. They want to reconstitute a form of the gold standard, fixed exchange rate that was the Bretton Woods system of fixed exchange rate where the dollar was the only currency which was convertible with gold but all the other currency with a fixed exchange rate vis-à-vis dollar. But they had learned the lesson of the past and they were quite determined to have a surplus recycling mechanism within this Bretton Woods international system. Where they disagreed. John Maynard Keyne was the representative of the Brits in Bretton Woods.. Keyne's determination to establish that surplus recycling mechanism formally to create an international system..he called it "international clearing union" that would transparently and as a result of institutional hardwork ensures that surpluses are redistributed as a productive investment or flows into the deficit countries in order to keep the Bretton Woods system. The post war if you want gold standard revamped going and to avoid a new 1929. **[15:00]**

The United States of America at the time being the surplus producer had a slightly different idea. They did not disagree with the concept that the surplus recycling had to take place but they just wanted to do it themselves because our surplus...we can distribute it anyway we want and we are not going to do it in the context of multilateral international institution which is precisely what they did. The Marshall plan is part of that story but not just the Marshall Plan. For 15-20 years, the United States of America was recycling a significant part of its surplus towards Germany and Japan trying to prop up these two major economies in order to create currencies that would internationally successful and powerful so as to create shock absorbers in case the American economy went into another recession and the fear would then be that without any other powerful regions within the capitalist world, the Soviet Union or some kind of shock recession would jeopardize the prosper of world capitalism.

This is how the Bretton Woods system works and how the gold era of Capitalism in the 1950s and 60s was founded. It died in 1971 famously on the 15th of August of 1971 when President Nixon announced the end of it. **[16:30]** Why did it die? Because by the end of the 1960s, the United States of America no longer had the surplus. So how can you recycle the surplus when you don't have it, And then something quite remarkable happened. We entered the second period..a weird and wonderful second post war phase during which American hegemony and dominance was founded on a reversal of the flows of capital and goods. To put it bluntly and I shall quote from Paul Volcker famous 1971 brief to Henry Kissinger "If we can't recycle our surpluses, we will recycle other people's surpluses" which just precisely what happened between 1970s and 2008.

The United States of America operated like a huge vacuum cleaner sucking into this land the net exports of Germany and of Japan and later of China ever increasing deficits..trade deficits registered but that was not a fault. It was part of the design and who was paying for those deficits? Well...those deficits were being financed by a tsunami of capital that was flowing from Germany from Japan and later from China back into the United States through Wall Street. **[18:00]** Why? Because the profits of the Germans, the Japanese, the Saudis, the Russians, later the Chinese were making far better returns in Wall street. This is a big story of how that was accomplished but this is what's going on. This reversal of surplus recycling during the Bretton Woods we had America recycling its own surpluses ... now we have America recycling everybody else's surpluses utilizing its own deficits as a locomotive that did it. That was the setting in which the Euro zone was born. The Euro zone is the child of this very weird and strange system of hegemony where the hegemon is basing his or her hegemony on deficits. During that era of the reverse flow of deficits and surpluses still a surplus recycling mechanism... German capital (capital goods, machinery) was helping capitalized Europe throughout the breadth and width of the European continent, you will find somewhere Siemens or (Eye Gare??????) or some large German manufacturers having provided things for _______. Yet Germany was never Europe's locomotive. The periphery of Europe **[19:30]** provided Germany with the demand it needed to keep its export-oriented growth going. Germany was effectively a net exporter of capital and consumption goods to the rest of Europe and the net importer of aggregate demand.. demand for those goods the products of the manufacturing sector. But to allow the Euro...what is now the Euro zone...back then the European common market to function as if in equilibrium in that manner, it was essential that the United States of America continued to create the demand for the whole of Europe through this vacuum cleaner that was sucking net exports both from Europe and Asia into the United States of America.

Germany was utilizing the rest of Europe as a vital space that provided with the demand which was necessary for the accumulation of German surpluses that were in turn helping Germany globalize. German corporations globalized both here in United States and in China later on. There was a threat to this process. The German industry was very well aware and so were the German policy makers. The threat was coming from what the economists refer to as a "competitive devaluation"...and I will give you a very simple example. **[21:00]** When Fiat found it hard to sell cars in Germany because Volkswagens technological innovations were faster, their factories were more efficient and so on and so forth. The Bank of Italy…the Central Bank of Italy..with its engineers, (evaluation and its _____???) vis-à-vis the German Deucht Mark and suddenly, the Fiats were competitive again. This was a threat to the strategy of globalizing German corporations and building German surpluses by utilizing demand that was imported into Germany from the rest of Europe. It was something that the German policy makers were very keen to undo.

This is the framework in which the Euro zone...the idea of a common currency emerged. Why did the European elites want to create the Euro zone? Each one of them for different reasons. The German elites had a primary concern compared to the devaluation. This is why they initially started the idea of an exchange rate mechanism that would limit the fluctuations of exchange rate within Europe.. when that failed, they were prepared to go one step further towards a common currency. The French elites had a different idea. They have a variety of motives towards a currency union. **[22:30]** Firstly you have to remember that the French trade unions were always quite utility energetic, and unlike German trade unions, were not interested in a corporate settlement but they are going for high wage rates and wage growth. Secondly the German elites were very keen to use the relative..the comparative advantage that France had in the financial sector vis-à-vis Germany. Germany was a powerhouse industrially..but French banks were far more globalized..far more advanced than the equivalent German banks..and French elites thought that by buying things together in Germany and France not only French labor will be subdued but also the French banking system will effectively take care of the financing of continental Europe.

And thirdly...equal importantly from the perspective of a French elite, the French are very good at administering things. Look at the OECD, look at the way that the Marshall Plan was administered, look at the Brussels, look at the way in which the European Union is being run. The German cannot even provide even though they have the power to impose.

A president of the European Central Bank just don't have good enough apparatchiks to do the job. So...this....let's go to Italy **[24:00]** and to my country...why do the great elites want to join a common currency.. simply because they had had enough with inflation..because inflation compared to devaluation of the Lira of the drachma will create an inflation which will ____ into the (store???) value of the well-off in our country. Our workers at the same time… those also had enough of inflation...their hard-won battles on the industrial field..strikes and so on...were very quickly reversed by the accerleration of inflation.. so their high wages in the end meant nothing. So there were many different motives of creating Euro zone. But the Euro zone was created along the line of the gold standard of the pre-1929 era not along the lines of Bretton Woods era. There was no surplus recycling mechanism.

Come to think of it during the run-up to the creation of the Euro, to get into the Euro zone, a country like mine or Italy had effectively to accept a slow burning recession in its real economy, in its industry, in its farming, in the sectors of the economy where the real material goods are being produced. If you look at the industrial data, not overall national income data, you will find that **[25:30]** the price of our country in the periphery paid to get into the Euro zone was effectively shrinkage. It was the only way by which to achieve the lower rate of inflation that were necessary in order to get into the Euro zone.

Now some people many commentators argue that "Oh Euro created those rules called the Maastricht Treaty for getting into the Euro zone that put several limits on the amount of indebtness of states 60% of GDP and 3% of GDP in terms of deficits in order to be allowed into the Euro. But then they allow countries like Italy that had 120% of GDP in debt to get in. So this was an error called by optimism and by political pressure. Well it was not an error. If I am right in my hypothesis of competitive devaluation especially vis-à-vis Italy was an essential motive for Germany to accept a transition from Deutsche Mark to Euro and Italy had to be in.

Do you know how Greece is going? I will tell you because a friend of mine actually engineered it. What they did was they copied exactly what Italy did in order to do a makeover on our statistics. You know you heard Greek statistics. There are Italian statistics, French statistics the Greeks are not inventive enough to create their own means of manipulating the data. **[27:00]** My mates are of the University of Athens also work of the Ministry of Finance of the time..simply copying exactly what the Italians did. They then got evidence what the Italians did. And then they said to the Europeans "Look. We've done what they did. If you don't let us in, we will expose you". And we will simply ask the question why is Italy allowed in when they have done exactly the same thing.

Not to mention Germany of course, right? Did you know that at some point, Germany valued the gold held by the Bundles bank and counted it as an income of the German state so as to reduce the nominal deficit? Now if Greece has done that, you know what we have been hearing about it. Anyway the Euro zone is thus created and what we have is a period of 8 years between 2000 and 2008 of low lethargic German growth in national income. Much lower than my country. My country was growing at 4 and 5 percent when Germany was barely growing at 1 percent. Compared to France, Germany was growing at a slower rate. Its prices were growing at the slower rate but at the same time the investment was growing much faster.

Germany reunification had unleashed a very large amount...number if you want...of worker **[28:30]** a pool of labor was discovered as if and it was not just East Germany because with the collapse of the Soviet Union and the Iron Curtain, Slovakia opened up to German industry, the Czech Repulic, Poland and that squeezed real wages in Germany..and real wages of German industry had to pale beyond belief. These were the changes that made between 2000 and 2008. German industry far more competitive creating a divergence competiveness in Euro zone. The rest of Europe, even France, was experiencing the slow burning recession which was necessary in order to enter the Europe zone, and then after the creation of the Euro zone was rewarded effectively by a very large flow of capital. Our productive capacities were shrinking relative to those of Germany but our income was rising. Why? Because we had all this capital flowing in. Where do the capital come from?

Two sources: Private money minted by Wallstreet banks and the city of London also known as the _______ that were creating tsunamis effectively of private money which then had to go somewhere to find higher returns to my country **[30:00]** to Ireland to Spain creating bubbles in the real estate sector and the public sector in my country. And the second source of capital flowing into the periphery of Europe was of course German profits which had to go somewhere since they were not spent in Germany because the growth rate of Germany was being kept low. So we had this amazing situation between 2000 and 2008 where periphery was going faster than Germany on borrowed money..on money that was flowing into our country from both Wall street and Frankfurt.

When in 2008 the pyramid of private toxic money created by Wall street, the city, and Frankfurt burned into ashes and collapsed under the weight of its own hubris then like a vicious cycle this capital just as fast as it moved in moved out like the capital usually does... think of South Korea 1998 or Thailand. And then we had the liquidity crisis which very quickly created an insolvency crisis in the most fragile part of the union. Greece being the case in point.

Once we reached that stage and once as George said the Greek crisis was treated by the Euro zone as a Greek crisis as opposed to a systemic Euro zone crisis. **[31:30]** And the medicine delivered was one of liquidation and shrinkage...the domino effect was bound to happen precisely as it did in the 1929 to 1932-33 period destroying the common currency of that era. Germany's refusal today to consider even the minimum steps that need to be taken in order to reverse this process of deconstruction of the Euro zone is not stubbornness...it's not an error...it's a straightforward application and dedication to the principles that built the Euro zone. The Euro zone was not an exercise in creating a federation or a common European home. It was an exercise... if I am right in my hypothesis...in maintaining a model by which German corporations globalized on the basis of aggregate demand imported from Euro zone.

The Maastricht Treaty was essential for NOT creating a surplus recycling mechanism the kind of mechanism that would be necessary you know to save the Euro zone now. So in a sense I completely and utterly understand Germany's commitment to not allowing the creation of a surplus **[33:00]** recycling mechanism within the Euro zone. The tragedy is by not allowing it...the Euro zone is doomed. Every single discussion in Europe... this is my last sentence....about fiscal unions and banking unions...if you look very carefully, the way in which the German officials are describing them...you will find that this is just cheap talk….the purpose of which is to confirm the whole talk about more Europe….more in the breach than in the observation. Thank you.

[Ugeux] Thank you very much Yanis and I think that the beauty what we are going to have tonight is that the three of us being on the ground in a number of ways in two different angles.. you've heard the story of the last 30 years during those 30 years.. Marshall was in investment management so I think it would be very interesting to find out from him when you live through that and how you invest... even so as I told you he is an academic he research at the Levy Institute at **[34:30]** Bard College....Research Fellow for the Economists for Peace and Security and he just became director of Institutional Partnership for the Institute of the New Economic Thinking. So we will have a combination again of points of view and then we will start debating it.

[Marshall Auerback] Probably collaboration of points of views since I don't have anything that's distinctively what Yanis said. I know that economists generally speaking cannot resist using visual aids but in contrast...I am not gonna use any mathematical equations or a bunch of Greek letters. I am going to draw from popular culture and start with a YouTube clip from the film "Misery" because I think it's a perfect metaphor for what is being experienced by Europe..so watch this.

[Video clip... two persons mumbling things......]

[Marshall Auerback] I could probably stop the talk right now and say that in a word has been the policy of the troika of the last 5 or 6 years.. but umm...you know....since I've been kindly offered more time so I should say a few words as well. If you are...if you are somewhat squeamish about what you've just seen....I apologize..but then just think of the five or seven year of collective punishment that most of the citizens of Greece have been experiencing or in Italy, in Portugal, Ireland, Spain.. you will get some ideas of what the problems are today. The European authorities within the Euro zone always do just enough to keep the patient alive and then when they look set to get off the drip and start to recover, they are hobbled by the austerity policy that has been imposed by the likes of the European Central Bank and therefore they are crippled so they stay alive. So when I hear people say that yes.. the ECB has written the check and has [39:00] therefore made the whole situation operationally sustainable.

That is true in strictly economic sense. But politics has a very fun way of intervening in these kinds of events and it is difficult for me to envisage how the democracies of these countries are going to continue to live in the 21st century equivalent of Victorian debtors prison which is essentially what has been requested of the likes of periphery countries right now. And if you just look at the data right now the Euro area unemployment is 11.4% as August of this year, the seasonally adjusted rate of....umm......was over the last 12 months of rates of halves by 1.2%. There are now 25.466 million men and women in the European Union... 27 countries..of whom 18.196 million were in the Euro area and they were unemployed by the August of 2012. So that's the record level unemployment. Over the last 12 months, unemployment has increased 2.2 million in Europe..... in

European Union 27 and 2.1 million in the Euro zone. So whichever way you wanna construct it, the Euro zone has failed to deliver what should be the priority of any system, which is to ensure that people have a secure income via work and [40:30] employment.

And I think this is a clearly (important??) point well beyond Greece. Greece has become the poster board, the whipping boy and even though this is a country that has consistently been cutting expenditures for the last 5 years..... having done exactly what they said they would do... it's never enough. The Greeks for example most recently wanted to make a cut in spending and lay off an estimated 15,000 civil servants by 2014. They also wanted to cut public spending by about 2 billion Euros. This is after 5 years of cutting spending. The troika of which consists of the IMF, ECB, Germans basically say that's not enough...they want another 13.5 billion in cuts. The Guardian of UK implies that it is not the EU that is playing hardball right now in Greece. It's the IMF...they are intent on securing high-pay arrangement with massive tax breaks for the upper end. This is the fund....that is...you know...umm....created the misery of untold other continents Asia and Latin America. So I would say...with all due respect to my friend Yanis that Greece is irrelevant in a sense that of itself not a significant issue....[42:00] 2% of the GDP and that's not the despair of massive human suffering that has been experienced there.

But it's clearly becomes an example of ____________ so it is becoming a morality tale of what you should watch out for if you want to ensure this doesn't happen to you. There has also been talk of _______ somehow if you just lopped off this little cancer called Greece..

you can somehow then cauterize the rest of the wound and therefore everything is going to be ok...and..umm...you can somehow manage to save the rest of the Euro zone.

Well..I think that's flawed on a number of different levels. One is...umm..if you look at the Treaty of Maastricht, there is no explicit exit mechanism, and Yanis has written some very good stuff on this...it was pointed out that you introduced a no-exit mechanism because you wanted to ensure or convince people that this was inviolable.... the currency union was permanent. So I think paradoxically..if you are serious about that you have to...umm...the European Monetary Union is only as strong as the support you're prepared to confer on the weakest member. If you really want to convince people that you are credible..that is the Union itself is not going to be destroyed..then you have to [43:30] back everybody.

It would be...umm...to use the analogy of the United States....I would suspect that...for example..states like Arkansas or West Virginia had been deficit countries for most of their existences in the union. But we don't say to Mississippi or West Virginia... "Well you are...your cost of living is 20% over value relative to the rest of the country. Therefore we want to internally deflate your economy. And if you don't listen by the way, we are going to throw you out of the union. In fact.. quite the opposite...we fought the civil war here to keep everybody in there. It seems to be the opposite problem".

Now..as I said...Greece is no longer the issue. Yanis wrote a very good piece recently called the Battle of the Two Marios..between Mario Draghi and Monti...umm..I am not even sure we are going to get that far. I think the real battle right now is between Mario Draghi and Mariano Rajoy, the Prime Minister of Spain. Here..you got a real diaster on your hands that it is Greece writ ..and you got a country with 25% unemployment...and ok...most of the audience here are law school students here... Columbia...probably 25 or younger... let's just take that as a given. If you are living in Spain, more than half of you would be unemployed right now. You might be lucky enough to be living with your parents but of course they are probably going to....[45:00] because mortgages are recourse loans, the parents probably on the verge of throwing out of their homes as well.. so the banking crisis accelerates.

So that's the problem you got in Spain right now. And there's another element which I think....umm..... not there has been to which insufficient attention has been played..and that's the fragile nature of the political institutions within a country like Spain itself.. and I mean...no disrespect to the Spaniards or the Great Nation of Spain but this is the country remember run by the generals but until the 1970s. The institutions of democracy are still relatively younger than this country. And add to that...on top of this...you have the problem of nascent separatist sentiment...so you got the Catalonians who have a very strong sense of autonomy likewise with the Basques the violence separatist problem that recently dissipated and given the trajectory of the current European policy, it's quite evident to me that this sort of problem can be exacerbated if we continue to go along the route that we are going.

So you can really understand why the Prime Minister of Spain even though he is in many respect profoundly sympathetic to the goals and the aspirations of the German chancellor. You can see why he is reluctant to place Spain under the kind of conditional austerity program that has been asked for [46:30] if they were to sign up for a bond buying program on part of the ECB. This is akin to the kind of deal that Clarice was getting from Hannibal Lector "silence of the lambs".

This is really on the cost of country like Spain and of course if Spain does go ahead, they are bound to fail. They have been failing so far because they have been cutting..they have been cutting very steadily. They surpised to have not being able to get their deficits any lower. Even though who wrongly diagnose the problem in Europe is being one of public profligacy are introducing policies which are actually exacerbating the problem.

You deflate these economies into the ground. Your tax revenues get to diminished, payments from the automatic stabilizers...social welfare expenditures increase. And surprise surprise….your deficit get up. And on top of the institutional limitations which we were brought up within the Euro zone. The two obvious ones I will mention....you probably know them already...they of course all give up their monetary sovereignty when they joined the European Union and they effectively convert themselves from being a national state with full fiscal sovereignty to being a satellite state of the union. [48:00] They became users of currency rather than issuers of currency. And secondly, they submitted to an arbitrary stability growth path which was designed by the German Finance Minister at the time ________ which stated that the overall public debt to GDP ratio should be no greater than 60% and budget deficit should be no greater than 3% of GDP on an annual basis.

Now..I will tell you...you can read any economic textbook...and I promise you...there is no empirical or theoritical justification for those numbers. You know..you can look anywhere...you can look in GregMankiw of the textbooks they give you at Harvard for the first year economic students. You can probably look at any economics textbook here they give you at Columbia. But I guarantee you won't find any justification for all that number. And you are probably wondering how those numbers just came out about. You know..it's interesting because the secret is finally been revealed.

There is a recent story ______________ which tells us why we have the 3% number for the stability and the growth path. The confession came from _________ who was a former senior budgetary ministry official. He was the inventor of the concept. He said ....and I quote "We came up with the 3% figure in less than an hour". It was the back-of-the-envelope calculation without any theoretical reflection. Mitterrand needed an easy rule that he can [49:30] deploy in his discussion with ministers who kept coming into his office to demand money. "We needed something simple - 3% Au quada". It was a good number that it stays the test of time. It was the reminiscence of the trinity. So..this is the number they came up with. You know...why not 1%...why not 2%...why not 5%?

You know...these are the (Mandarins???)... these are the ________. These are the so-called policy elites. This is how policy making... it symptomatize of all the problems we have... yet this is treated as something akin to the Holy Gospel. So I mean....that's another problem you have. And as I say..there is no rational reason why we have these figures. But we stick to them as if it's a Bible. It's clearly increasing problem and the idea of course...the sad tragedy is that the noble aspirations which underlies the European Union..the desire for ever closer union to prevent the horrors of the Second World War...prevent the dark aspects of the continent's past from being repeated...are actually being exacerbated by the harsh implementation of this rule.

In Greece right now...the Golden Dawn which is the neo-Nazi party...now its popularity stands at 22%. It's the third highest party in Greece...it's now ahead of the Passo..[51:00]. if you hook up in the city with a new democracy and it's the Golden Dawn. You have Marine Le Pen establishing herself in a very significant way in France...and my guess is...you know..the terrible thing so far...the populism has found the repository non-mainstream Europe parties. That's why I think there has been little political tractions gains so far because even though you listen to..you know...I was listening to an interview not too long ago with the leader of the far right party for the Austrian was speaking about the Euro..and his criticisms were very very cogent. The problem is that the rest of his policies would create a dystopian nightmare in the country.

So I think...what could change the political dynamics significantly in the years ahead is when a mainstream party begins to started embracing into some of the populist rhetoric and indeed start to explicitly threaten a Euro exit. And if I have to make a guess, I would say that a very strong possibility might be Italy. Silvio Berlusconi...I am not going to mount any defense of the man.. his Bunga Burga party or his preferences what he does in his private time..but I will say this...the man has very good political antenna and he did respond to the tangentopoli crisis in the [52:30] mid 1990s by creating a brand new Italian political movement for the Italians which essentially wiped the mainstream parties off the map in Italy. So...whatever you could say about the man...there is a lot you could say..I know... he has certainly got good political instincts. He gets started to make very very strong anti-Euro noises and it's worth remembering that even though he is no longer Prime Minister, he is still the leader of the largest party within Italy. A man who is literally a comedian a clown.... he's now leading a party which has a high substantial amount of votes in Italy in the polls right now.

It would not surprise me that if we get to the stage where Mario Monti does submit to some of the conditionality that has been demanded of anybody who submits himself to ECB assistance program decides to go in there..and Italy has...it has the impact on Italy that..I expected will do... that might be the time that Mr. Berlusconi might strike. There's no reason why the conditions in Italy should be any different. The fact that matters is that that country has not grown since it's been in the European Monetary Union. It's basically been flat all the way through. And by the way speaking of the Altering of the figures that Yanis has mentioned for...there is a very good paper that is done by an Italian professor Gustavo Piga where he illustrated [54:00] the creativity with which the Italians use the derivatives to mask their own public debt to GDP ratio when they entered the European Monetary Union.

The person who is heading up.... who is the deputy treasury at the time... one of the senior bureaucrat within Italy was Mario Draghi. So there is a certain justice in the fact that he is now being forced to deal the... shall we say... consequences or fruits of his creative accounting genius. There are...I think..some solutions which have been proposed and offered...and I think we will go into more details when we discuss it..but what I will say is that I don't think the Union can survive in its current incarnation. My preference would be a coordinated dissolution. There is talk particularly within Germany. You will hear a number of business leaders who are saying in spite of the mercantilist benefits in that has been derived from the adoption of Euro. They have talked about leaving the Euro zone or at least creating a new hard currency bloc and leaving the periphery countries to have a collective devaluation.

Among the leading proponents of that school of thoughts is Hans Hinkle. He talked about saving Europe but not the Euro. So maybe we can have two currencies....we can have one called ________ and maybe what we can call the other one [55:30] "Pseudo" or maybe we can call the sorrow..something like that. The point is that it's superficially attractive idea.... you get one of re-valuation for the Germans..one of de-valuation for the other side. Of course I think Germany would pull out..the whole thing would just collapse and I think if you are going to go that further, why not just have a coordinated dissolution?

The other point that I would make would that sort of a situation is that it puts countries like France in a very difficult position. Because France will have to make an existential choice. This is a disciplined tectonic country that has made dramatic style reform which has impacted Mediterranean countries. It's an interesting choice as Yanis has said..it's not a country that...maybe would accede to the same kind of wage discipline that Germans have exceeded to. This is a place after all guillotine was invented and in the national anthem..they do call out _____________. There maybe a little bit more spunk we get to this level.

But the other point is that if France for reasons of national dignity decided to sign for the new Deutsche Mark bloc or Neuro whatever you want to call it. It's going to put them into tremendous competitive disadvantage vis-à-vis countries like Italy. Its manufacturing profile is very very similar to that of Italy and if Italy were to drive this huge competitive advantage would actually create a huge problem for the French economy because they haven't [57:00] experienced anywhere near the “reforms” of the German economy. By “reform”..by the way... I should take _________ I use that term inverted to commerce because in fact the reforms of the German introduced where simply massive transfer of labor to capital.. the hard reform..they simply gave Germany first mover advantage... they were the first to cut wages across the board..and they did so at a time where global economic growth..so when Germany said "we actually took the pain and you can do the same thing"... they did it at a time of economic growth and it helped them to gain first mover advantage. It's impossible to see that happen..everyone doing at the same time..you'll run into the old fallacy of composition problem. So Germany is I think being quite disingenious when it suggests that everyone should go that route.

And besides which it actually creates to substantial casualization of labor within the German market itself. The old Wirtschaft was a feature of the German economy for most of the post war period is I think being inviserated even there..and my guess is that if you have this withdraw Germany from the Euro zone and you have the revaluation, that will get you into a situation whereby a German manufacturer would use a threat of relocation to some of the new low cost areas of ....say Portugal or Spain to extort even further the reduction in wages from the average German workers. So I suspect that this wasn't going to work. [58:30]There is one other point that I should probably mention again...it's a classic case of self-inflicted nature of the problem..which is you have a silent bank run going on across Europe right now. This is actually...umm...you couldn't have picked a greater speculative Doom's Day Device to do this and by the Treaty of Maastricht...because under Article 66 of the EU Treaty there is complete capital mobility within the Euro zone. And the many of you introduced the idea of booting someone out as you have with Greece or the threat of covertibility which Mario Draghi himself has talked about...that of course if you are a depositer in Spain and you've got money in a Spanish bank account and you are worried that somehow this could be redenominated per se, or you are Greek and you're worried that your savings will be _______ because you will be redenominated in worthless or increasingly worthless drachmas and of course you will move your money. And it's very very easy. You take your money, your boss loan a bank, you walk down a street from the bank you had in Spain, you put into a Deutsche Mark account and BOOM..you know..you're all set.

This money can continue to go on and you are left in this increasingly untenable position where the European Central Bank effectively backs off the entire deposit base of the periphery country. This is symptomatize of the kind of incoherence that are mounting increasingly day after day within Europe and it's being exacerbated by this horrible implementation of physical austerity program which are actually even counter-productive to [1:00:00] the misguided..umm....disease..or desire for a cure for public profligacy which is a non-existent disease in the first place. It's a bit like blaming a thermometer because it records a temperature that someone who has an influenza. And at this point..I'll leave it at that and open it up for questions now. Thank you very much.[1:00:22]

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