A Greek Lesson in Democracy

By Sahoko KAJI

Alternative Interpretation of European Crisis

In October 2009, a new, socialist government led by Prime Minister George Papandreou came to power in Greece. Before long, the world was told that the ratio of Greece's government deficit to GDP was around 13%, much higher than the previous government had admitted. The rest is history, as they say – an on-going history. After agreements on rescue packages and initiation of reform, some people are still talking about a possible breakup of the euro area. Many blame the euro for the crisis, arguing the euro should not have been introduced in the first place because the euro area was not an optimum currency area as economics teaches.

This article offers an alternative interpretation of the crisis by explaining the following three related points. One, the issue is bigger than the euro, involving a broader aspect of European integration. Two, the question is bigger than Europe; it is about how to improve governance at national and supranational levels. Three, in the end this is a Greek lesson in democracy, which teaches us the importance of asking how much sovereignty must be given up for overall stability.

Issue Bigger Than Euro

A country that joins a single currency area loses its monetary policy autonomy but frees itself from the worry of exchange rate gyrations. For euro area members, there was the added benefit of lower interest rates as the euro successfully inherited the credibility of the Deutsche mark *(Chart 1)*. Lower interest rates pose no danger if the government is not profligate, wages and other production costs are kept under control and funds are used productively both on the demand and supply sides. In contrast, if these conditions are not met, a bubble is likely to develop.

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

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

Countries such as Greece are in trouble because they enjoyed the benefits of low interest rates without doing their homework. The homework was structural reform. True, the low interest rates were brought about by the euro. But members should have used the resulting improved economic climate as a chance to push through painful reforms. Instead, they squandered the opportunity given by the euro. The euro area crisis is due to insufficient reforms rather than the euro itself.

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

European Efforts to Improve Governance

The Europeans are now fully aware of this need. A task force headed by European Council President Herman Van Rompuy was formed in May 2010. The Van Rompuy Task Force has four main tasks: strengthening budgetary discipline through the stability pact, reducing divergences in competitiveness between the European Union's member states, ensuring an effective mechanism against financial crises and improving economic governance and coordination. After an informal EU Summit on September 16, 2010, President Van Rompuy confirmed that EU leaders agreed to enshrine EU budget rules in national legislation and that progress had been made on sanctions for violating the Stability and Growth Pact "even if more work is needed." The EU president will present a full report of his task force to the European Council in October 2010.

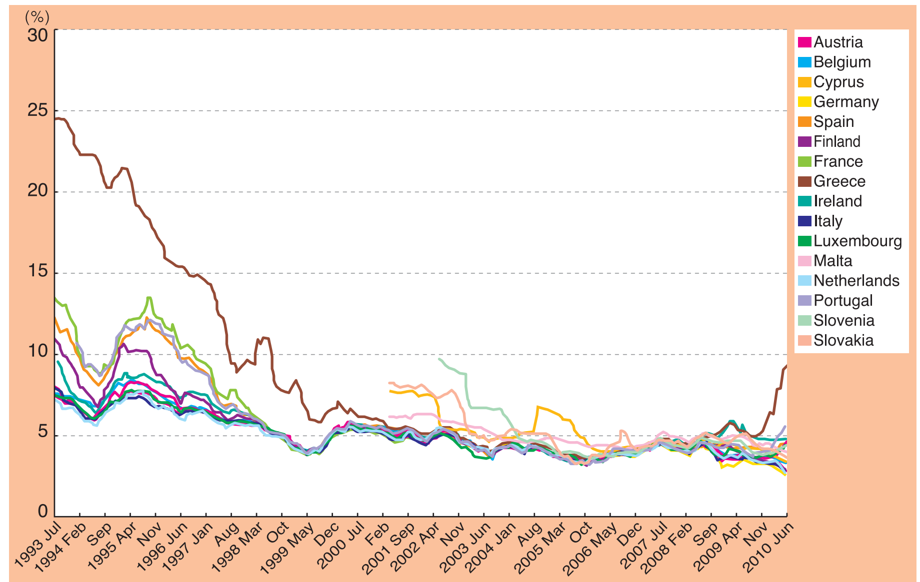
Budgetary decisions are not the only aspects that need stronger

governance. The Van Rompuy Task Force's agenda includes "reducing divergences in competitiveness between the member states" and "improving economic governance and coordination." The EU's Lisbon Strategy, introduced in 2000, was supposed to make Europe "the most competitive and dynamic knowledge-based economy in the world" by 2010. The strategy called for reforms that would encourage innovation and worker participation. But the Lisbon Strategy used the "open method of cooperation," whereby members were evaluated by one another to create peer pressure with surveillance by the European Commission. There were no penalties for failing to meet specific goals. The open method was adopted because members wished to respect each other's sovereignty over policy areas such as employment and social protection. Because of this, the strategy failed to bring about results. Now the EU has a new strategy, "Europe 2020," to make Europe "a smart, sustainable and inclusive economy delivering high levels of employment, productivity and social cohesion." The new strategy is likely to have the same fate as the Lisbon Strategy without seriously "improving economic governance and coordination."

The 750 billion euro rescue package agreed in May 2010 gives the EU only temporary reprieve. Even though the weak euro is reviving economic activity in the euro area, sources of turbulence remain. The banking sector is not in good health, and progress in structural reforms is insufficient. Some governments may yet default. Undeniably, Europeans really do need to get serious. On September 2, 2010, EU leaders agreed on a new method of financial-sector supervision. The proposal is to establish three new EU-level watchdogs for the banking, insurance and securities market sectors in London, Frankfurt and Paris, respectively. National authorities will retain the right to supervise national institutions. But the watchdogs will write common technical rules and standards, and in "emergency situations" could acquire additional legally binding powers. Consultations on governance reform in Europe are said to have gained speed in reaction to the passage of the US Dodd-Frank Financial Reform Bill in early July 2010, but of course speed is not everything.

CHART 1

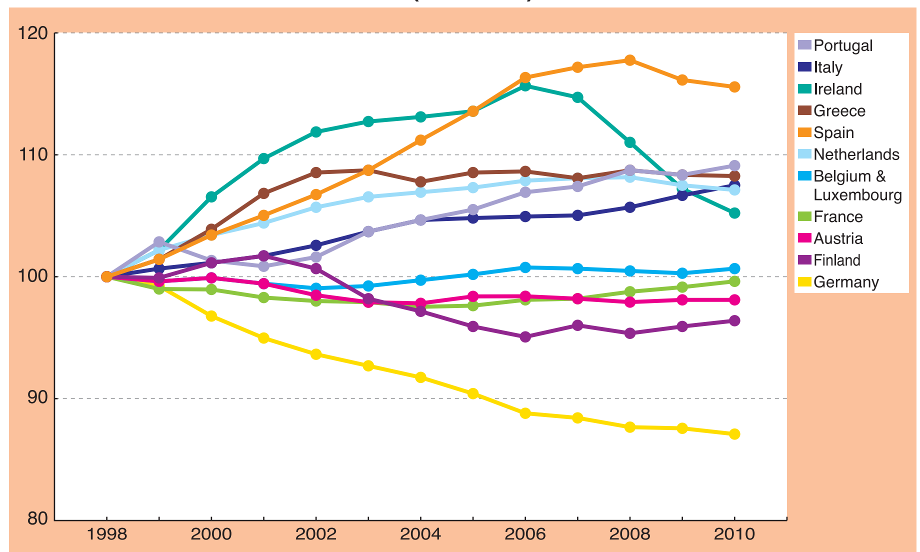
Long-term (10-year) interest rates



Source: European Central Bank

CHART 2

Real effective exchange rate trends, based on GDP deflator (1998=100)



Source: European Commission

Question Bigger Than Europe

Governance is not an exclusively European issue. Governance needs to be improved at the national level in many other countries around the world as well as at the global, supranational level.

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

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

A Lesson in Democracy

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

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

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

The natural reaction is to want to avoid a repeat of such a crisis. Unfortunately, a repeat is likely without significant reconsideration of how democracy works, at national and supranational levels.

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

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

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

There are two layers to the problem. The first is that there is no effective supranational body to which democracies will cede their national rights. The second is that even if voters accepted loss of sovereignty to a supranational entity, if the latter did not make good use of the sovereignty given up, stability and prosperity would not be achieved. But we need to start somewhere, for example with a supranational entity that ensures mutual consistency in regulation. Such an entity could also be a forum for information exchange, where all participants come to share a common understanding of the state of affairs.

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

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