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Economists are not known for making bold predictions or giving unconditional advice. This professional trait was strikingly expressed by President Harry Truman, when he famously said: "I was in search of a one-armed economist, so that the guy could never make a statement and then say "On the other hand"".[i]

Yet, the economists' discussion of the euro seems to be the exception to this saying. Right from the start, and coming mostly from Anglo-Saxon economists, there was no dearth of predictions that the euro would fail. The most extreme predicted a failure so dismal, that it might even provoke a war among European states.[ii] The contrast between these views and those held by European economists, especially those associated with the European Commission, seems to rather vindicate George Bernard Shaw's aphorism: "If all economists were laid end to end, they would not reach a conclusion".[iii]

Today, regarding the euro, there is further evidence that not only George Bernard Shaw seems to be right but also Harry Truman would have no problem finding one-armed economists. Even among European economists, there are diverging views and predictions. A recent example of disputing economists offering different bold predictions, is that of the well-known professors Wyplosz and Neumann.

Professor Charles Wyplosz addressed an open letter last November to the head of the Bundesbank, Dr. Jens Weidmann.[iv] In this, he asserts that "the debt crisis will not come to an end until the ECB intervenes as lender of last resort". If the ECB refuses to intervene, as Dr. Weidmann would have it, then the euro zone will break up.

Professor Manfred Neumann, on the other hand (if such an expression is not offensive in a discussion of one-armed economists), totally disagrees. In a recent conference,[v] he sided fully with Dr. Weidmann (who was his doctoral student) on the needlessness and indeed undesirability of ECB intervention. Moreover, he made the bold prediction that Greece would be out of the euro zone by the end of 2012.

These divergent views and predictions are clearly based on differences in the diagnosis of the urgent problem facing the European economy today. It is therefore essential to briefly examine this, so as to clarify the nature of what has come to be known as the euro crisis.

1) What is the euro crisis?

In the first instance, it is the inability of three European states participating in the euro zone, Greece to start with and then Ireland and Portugal, to finance their debt. The inability of these states to borrow in order to meet their obligations might prove contagious and could threaten a number of other countries with a high ratio of debt to GDP. This is because the potential default of a member of the euro zone heightens the perception of risk for other member countries, thus raising their costs of borrowing and pushing them also towards default.

Moreover, an aggravating factor is that the whole euro zone's banking and financial system is fragile and, following the American subprime debacle, it is widely perceived to be in a weak condition. The difficulties in financing the sovereign debt of the three countries above clearly weaken it further, since banks across the euro zone hold sovereign debt issued by the three peripheral countries.

To the extent that the state in other European countries might be obliged to step in and strengthen its own banking system, the risk of that state's defaulting increases. This increases its cost of borrowing, which further increases the risk of default. This vicious circle of increasing risk perception converges to a cost of borrowing that may be high enough to actually make default inevitable. So, what initially surfaced as a Greek debt crisis risks engulfing many other countries, most importantly Italy, Spain and Belgium, thus becoming a crisis of the euro. If this is not resolved, the existence of the euro zone, at least in its present form, will be endangered.

2) What triggered the crisis?

As George Soros has pointed out, "the euro crisis is a direct consequence of the crash of 2008", when Lehman Brothers was allowed to fail and the global financial system started to collapse. The European finance ministers correctly responded to this threat by guaranteeing, in November 2008, that no other financial institution of systemic importance would be allowed to fail.

"Angela Merkel then declared that the guarantee should be exercised by each European state individually, not by the European Union or the euro zone acting as a whole. This sowed the seeds of the euro crisis because it revealed and activated a hidden weakness in the construction of the euro: the lack of a common treasury. The crisis itself erupted more than a year later, in 2010".[vi]

Mrs. Merkel's declaration ensured that the markets' attention would be concentrated on whether each individual country's public finances could support its own banking system. After this, it was inevitable that the economically weakest countries with the least healthy public finances would sooner or later come under attack. Greece was the first, mainly because of its boundless political strife and the inexcusable falsification of national statistics for political advantage.

3) What is the root of the crisis?

Here we reach the root of the present crisis. It is now clear that the absence of a common treasury rendered the construction of the euro deficient from the start.

Was this not realized at the time? It seems not. It was believed that the conditions of the Maastricht Treaty stipulating, that 1) the debt to GDP ratio should not exceed 60% of GDP and 2) there should not be budget deficits over 3% of GDP, were enough to ensure avoidance of excessive debt.

The above rules were, of course, breached right from the start. Italy, Belgium and Greece joined the euro zone with debt to GDP ratios far above 60%, on promise that these ratios would tend in the future to converge towards the 60% threshold. Moreover, France and Germany have breached the 3% budget deficit rule in order to avoid recession at least 6 times each, with the total number of breaches reaching 30.[vii]

Unfortunately, the official thinking has always been that there is not any serious weakness in the euro construction other than the poor implementation of these rules.[viii] The December 2011 European Summit established a new legally enforceable “fiscal compact”, with the European Commission approving national budgets in advance. Government budgets must be balanced or in surplus, with the annual structural deficit not to exceed 0.5% of GDP, and highly indebted countries must reduce the debt in excess of 60% by 1/20th on average annually.

Leaving aside the wisdom and enforceability of an arrangement,[ix] which deprives governments of their most potent anti-cyclical tool by effectively making Keynesianism illegal, could this be a credible response to the euro crisis? Is the crisis solely due to excessive government borrowing? Or is it, as Soros claims, the absence of a common treasury and the German insistence on a nationalist rather than European approach to the threat of a financial meltdown that is at the origin of the crisis?

If one focuses on the Greek and Portuguese cases, the official thinking might seem credible. But it is clearly given the lie by the case of Ireland. There is no question that Ireland was a model of fiscal rectitude. The main reason that the Irish government had to borrow heavily was in order to save its banks. If Merkel had not ruled out a European guarantee for the banking system, the Irish banks would not have come under attack and the Irish sovereign debt (which was just at 25% of GDP in 2007) would be perfectly satisfactory. (It may be noted that Moody’s rated it Aaa until 2007 and Aa2 until the end of 2010. This is more than two years after the government was obliged to guarantee, without any European support, the safety of the over-extended Irish banks).

Similarly, Spain had a debt of about 30% in 2007 and its debt ratio was even in the beginning of 2010 less than that of Britain, France and Germany. But its fragile banking system, in combination with the bursting of a real estate bubble, put its sovereign debt under great pressure following the debt crisis of Greece, Ireland and Portugal.

Consequently, it is difficult to accept that the euro zone’s problem is excessive sovereign debt. This official diagnosis misses *the root of the crisis*, which *is to be found in the unfinished construction of the euro*. As a result, the remedy proposed is not only likely to be ineffective but risks damaging the health of the euro zone both economically, by deepening the recession, and politically, by undermining solidarity and feeding chauvinist attitudes. It may thus, inadvertently lead to the breakup and unraveling of the euro zone.

The appropriate remedy based on the correct diagnosis should be to complete the construction of the euro by creating a common treasury. This would be in accordance with Jean Monnet's[x] "theorie d'engrenage", which has guided the building of Europe from the very beginning. This theory is based on the idea that a federal United States of Europe is desirable and, given that this is not at any time feasible politically in one step, a succession of steps of unequal amplitude will be required over time. The theory postulates that any one step will lead to an unfinished construction but, through its unfinished nature, it will create forces pushing forward towards the further building and eventual construction of a federal European state. The name of the theory (engrenage) evokes an analogy with a complex clockwork-type mechanism made up of numerous cogwheels of varying size, in which any cog movement is transmitted to the whole mechanism pushing forward the other cogwheels.

4) What are main lessons of the crisis?

The euro crisis has recently abated but Europe's problems are still not over. There are certain mistakes and omissions of policy-making, which seem clear by now. What are the main lessons that can be drawn and, if heeded, may help in improving economic policy in the future?

The most obvious ones have been clearly presented by Lawrence Summers (former US Treasury Secretary, Harvard Professor and former President of Harvard University).[xi] I summarize them briefly below, before proceeding to discuss at length a less evident one, which has received little attention by economists.

1) *Timid actions, which do not patently exceed the minimum necessary to achieve stability, are likely to fail*. This is especially the case, if they are accompanied by dubious assertions and announcements of vague programs. The reluctance to assist Greece at the start, the subsequent about-face with an inadequate first Memorandum and initial PSI, the underfunding of the EFSF and the ESM are relevant examples. Europe's half-hearted attempts to resolve the crisis, clearly demonstrate that "attempts to purchase solutions on the cheap are more likely to exacerbate problems than to resolve them".

2) *Sovereign debt crises*, if not actually caused by slow growth, certainly *become worse by lack of growth and deflation*. As shown amply in the present crisis, the efficacy of austerity measures is often overestimated by neglecting the adverse effects on growth and hence on tax receipts. The deterioration in the business climate and the consumers' confidence, which the austerity measures bring about, contributes to this and causes a slowing down of the economy, even when the austerity measures are not fully implemented (as seen in the Greek case).

It is worth mentioning that the IMF has announced at its October 2012 annual meeting in Tokyo, that fiscal multipliers have been greater than normal in this recession. Negative multipliers have been in the range of 0.9 to 1.7, instead of the standard assumption of 0.5. This is because, with interest rates near zero and credit strongly constrained, the private sector did not compensate for the budget deficit reduction by expanding private investment and consumption.

3) *Containing systemic financial risk through fiscal contraction is not enough to restore growth*. Fiscal contraction may be necessary in order to reduce debt and eliminate systemic financial risk, so that future growth is based on a healthier and firmer foundation, but it cannot be expected to initiate or encourage expansion of economic activity. The historical examples of expansionary fiscal contraction were based on the possibility of devaluation and strong demand for exports. Both of these conditions are absent in Greece and the other peripheral European economies, which are presently subjected to austerity programs.

5) What is the less evident lesson?

Let us now move on to our final lesson from the recent handling of the crisis. This lesson is less evident in economic writing because of the strong tendency (one could even say, professional deformation) of economists to assume that economic agents are fully rational. Despite the evidence garnered by psychologists and behavioral economists in the last few decades, which convincingly demonstrates the doubtful validity of this assumption, economists find it difficult to admit the importance of non-rational behavior.

What then is the less evident lesson?

This is that human emotions can play an important role in the march of history while rationality cannot be assumed to always prevail.[xii] In particular, *national pride and prejudice* are psychological attitudes or traits, which *can influence the unfolding of events in uncertain and dangerous ways* that do not make rational sense.[xiii]

To substantiate this claim, it is necessary to dwell on certain recent events in some detail. In fact, I will devote the central part of my talk (with minor digressions) on the discussion of this issue.

On Sept.16, 2011, US Treasury Secretary, Timothy Geithner, was invited to give a speech at a meeting of the euro zone finance ministers in Wroclaw, Poland. Geithner warned of "catastrophic risks" if the seventeen eurozone countries did not act decisively to resolve the sovereign debt crisis. Though he did not propose any particular plan or action, he urged Europe to provide its bailout fund with more firepower, in order to send a strong and convincing message to the markets. For this, he pointed out, it is also essential that governments and the central bank speak with one voice and there is no "loose talk about dismantling the institutions of the euro".

This advice sounds quite reasonable, yet it was badly received, judging from the response it evoked. Jean-Claude Juncker, president of the Eurogroup finance ministers, said that European officials did not care to have detailed discussions about expanding their bailout fund "with a nonmember of the euro area". Didier Reynders, the Belgian finance minister, said that Mr. Geithner should listen rather than talk. Finally, Maria Fekter, finance minister of Austria, "found it peculiar that, even though the Americans have significantly worse fundamental data than the euro zone, they tell us what we should do".

It may be true that Europe's fundamentals are not too bad. In Mr. Trichet's words (Trichet was the Governor of ECB until January 1, 2012) "if the euro zone were a single country, it would actually look like a model economy, with a small current account surplus, a primary budget deficit of less than half that of the UK and the US, subdued household debt, low inflation and a little growth". Moreover, its consolidated debt falls short of the US and Japanese ones. But to disregard the present vulnerability of the euro and the threat it poses to the world economy, and the American one in particular, would be inexcusably complacent.

The state of public confidence in the American economy is extremely low and this bodes ill for its growth prospects. As Yale's Prof. Robert Shiller has noted, the expectations of the American public of how well the country will be doing over the next five years are at the lowest ebb in thirty years.[xiv]

Sovereign debt defaults in Europe and, even more so, a collapse of the euro zone will affect the American and indeed the world economy not only through their effect on the state of confidence but also, and more immediately, through the financial linkages of an ever more interdependent and intertwined global economic system. It is, therefore, not surprising that the American government is concerned about Europe's sovereign debt problem. The fact that the country is soon in an electoral year adds urgency and enhances this concern.

The above explanation of the US government's concern for Europe's financial stability may be contested by those holding the not uncommon view, that Europe has an antagonistic relationship with the US in international finance. Consequently, it may be argued, America's fundamental interest is in undermining rather than saving the euro. This view may, at first sight, seem plausible but does not hold water, at least under the present circumstances.

It is true that the existence of the euro and its expanding role as a medium of international payments makes it an international reserve currency in competition with the American dollar. This clearly reduces the seigniorage gain and restricts the margin of maneuver that the US possesses in running current account deficits without risking a fall in the dollar's exchange rate. But the relationship between the US and Europe is symbiotic rather than purely antagonistic.

A symbiotic relationship includes both competition and cooperation as potential modes. Competition is not unlimited but bounded, giving way to cooperation when there is a threat to the existence of either side, while cooperation is always possible and may arise even when gains are unequally shared between the two sides. Symbiotic relationships are quite common in nature but may also be observed in international relations and economic life. Despite the emphasis on competition in economic thinking, there are many instances of cooperation in economic life and a lot more for which cooperation could be a superior alternative to competition. Harvard's Prof. A. Brandenburger with Yale's Prof. B. Nalebuff, coined the term "co-opetition" (in their book of the same title[xv]) to describe the coexistence of competition and cooperation, as well as the alternation between the two behavioral modes, in actual business practice. Moreover, they argue convincingly that business strategies, which recognize and use the potential for cooperation, can be far superior to strategies resulting from a purely competitive mentality.

It seems quite probable that the US government views America's relationship to Europe as a symbiotic one. This interpretation seems, at least, to be in accord with the sequence of events, which followed the Eurogroup finance ministers' meeting.

Mr. Geithner did not give up in the face of European criticism. About a week later, at the annual meeting of the IMF, he warned that the European debt crisis is "the most serious risk now confronting the world economy" and strongly emphasized the need for immediate action on the part of European leaders. In addition, two days later, US President Barack Obama made equally strong statements to the same effect. His exact words were that "They (i.e. the Europeans) are going through a financial crisis that is scaring the world, and they are trying to take responsible actions, but those actions haven't been quite as quick as they need to be". He attributed the problem to the fact that the Europeans "have not fully healed from the crisis back in 2007 and never fully dealt with all the challenges that their banking system faced. It's now being compounded by what's happening in Greece".

What was the European reaction to Obama and America's second call for urgent action? It was clearly not better than the first. The German finance minister Wolfgang Schauble responded that "it's always easier to give other people advice" and "I don't think Europe's problems are America's only problems", while other German commentators dubbed Obama's remarks "arrogant" and "absurd".[xvi]

Is there any rational explanation for such a rebuff of a seemingly reasonable concern by an erstwhile trusted ally and important trading partner? This is where pride makes an entrance. It is difficult to think of any reason other than irrational and misguided national pride in explaining this stance.

We have therefore seen pride at work; what about prejudice? For this, we must ask the next obvious question arising from our account of events. Why has it been so difficult to take action in order to safeguard the euro and the European banking system?

To answer this question, let us consider the most effective solution to Europe's financial crisis. This is clearly to remedy what Soros called "the hidden weakness in the construction of the euro". A European Treasury needs to be created. The common treasury must be able to raise taxes across the euro zone, coordinate and control national fiscal policies, issue bonds and perform all the functions required of a federal state treasury, while being accountable to the European Parliament. There is no doubt that this would be a truly great step forward in the deepening of European integration and the realization of a federal state.

The second major reform that is needed concerns the role of the European Central Bank (ECB). The ECB should be responsible not only for the containment of inflation but also for the proper functioning of the financial system across the euro zone, being empowered to control the banking system without constraints and operating, without inhibitions, as the lender of last resort for both financial institutions and national treasuries.[xvii]

Either of these two reforms could have been a sufficient response to the crisis. The two reforms constitute jointly the first-best solution to Europe's financial problems. If they were adopted, not only the present crisis could immediately come to an end but also it might have served as a unique opportunity for a decisive step towards federal Europe. This would have been in the best tradition of European integration, which has tended to proceed by resolving problems caused from incomplete though politically feasible previous measures. But politicians, with their eyes firmly fixed on their electoral chances and on political alliances necessary to governmental coalitions, are not ready for such major advances at present.

Instead, all kinds of "red lines" are drawn by the main decision-makers, according to their estimations of what is politically feasible or non-feasible, given their own interests and targets. Consequently, the most effective response is ruled out and we are inevitably in the realm of second-best solutions. As the theory of the second-best implies, there is no clear criterion in ranking such solutions and deciding which is superior, which explains why it is difficult to arrive at an agreed course of action. Moreover, in the present context, the "red lines" which determine the possible second-best solutions are themselves heavily dependent on the political leaders' personal courage and motivations. And, of course, prejudice in the electorate's mind, as well as in that of the leaders, is an important factor in drawing the "red lines".

Prejudice against the creation of a European treasury is, of course, understandable among euro-skeptical political parties. Any move towards a common treasury clearly implies a reduction of national sovereignty, as national fiscal policy will need approval and may be subject to a possible veto by institutions at the European level. Moreover, a common treasury would have to take a view of the economic situation and needs throughout Europe and redistribute resources, most likely from the strongest to the weakest countries and regions. It is, thus, not surprising that political leaders in Germany and other economically strong countries tread cautiously with respect to this reform. Despite the attempt by Mr. Trichet to put the creation of a European Finance Minister on the agenda, all that is contemplated at present is stricter monitoring of public finances and the imposition of sanctions if agreed plans are violated. This on its own is clearly insufficient as a response to the crisis.

Prejudice against expanding the power and responsibilities of the European Central Bank(ECB) is more difficult to understand. This "red line" is based on the German fear that by allowing the ECB to directly lend to governments, the euro will be debased and hyperinflation will follow, as happened to the Weimar Republic's mark in the 1920s. But central banks all over the world lend to their governments without causing hyperinflation. The remote possibility of huge mismanagement sometime in the future does not justify taking today the extreme risk of a financial meltdown, that can easily be averted by an adequately empowered central bank. As Prof. Willem Buiter, Citigroup's chief economist and former board member of the Bank of England, has noted: "The blanket prohibition against directly lending to governments is a complete idiocy… Just because it can be mismanaged does not mean you have to throw the tool away. You can drown in water but it does not mean you cannot have a glass when you are thirsty".[xviii]

The "red line" drawn by Mrs. Merkel, when she declared last October to the German parliament "all models that depend on ECB participation are off the table", seems to be a case of unfounded, pure prejudice.

6) What is the present state of the euro crisis?

On the same day that Mrs. Merkel proscribed any widening in ECB's role, she also affirmed that "Germany, regardless of political party, will protect the work of European unity". As it progressively became clear, in the course of the past year, that European unity was threatened from the possible collapse of the Spanish and Italian public finances, Mrs. Merkel fortunately changed her mind about the role of the ECB. In the June Summit, she agreed, although seemingly reluctantly, to a banking union under the supervision of the ECB. Following its establishment, direct aid by the ESM to banks and not only to states was then to become possible. This is of great importance because the rescuing of any vulnerable bank in a country would not any more involve an increase in the country's debt and a worsening of its debt to GDP ratio. Consequently, the vicious circle between the banking crisis and the sovereign debt crisis is broken.

This did not prove enough to calm the financial markets because, apart from vagueness regarding a number of practical details, it could not be put into effect before the end of the year at the earliest. Consequently, Mr. Mario Draghi, successor of Mr. Trichet to the helm of the ECB, had to announce at the end of July that the ECB will do whatever is needed to preserve the euro.[xix]

But the real turning point came on September 6. Mario Draghi launched an unlimited bond-buying program by the ECB (named Outright Monetary Transactions), which would provide a "fully effective backstop to avoid destructive scenarios … in the euro area". Despite strong objections by Bundesbank President Jens Weidmann, Mrs. Merkel evidently sided with Draghi. As a result, the euro crisis has now abated and risk premia on Spanish and Italian bonds have receded.[xx]

It is worth noting that the unlimited buying of a country's bonds is not unconditional. The condition is that the country must first ask for EMS assistance and must accept to implement agreed structural reforms under the supervision of the troika. But just the announcement that any country in extremis would be saved by the ECB in this manner, was sufficient to remove the risk of bond default, lower bond yields and, thus, reduce a country's borrowing cost.

Finally, another recent development has had a positive impact. The calming of the bond markets has been further abetted by the decision of Germany's Constitutional Court on September 12 to dismiss a complaint against the European Stability Mechanism (ESM).

So, is the euro crisis over?

7) What are the future prospects for Europe?

It has been argued above, that the root cause of the crisis is the absence of a common treasury. As long as this is missing, the euro crisis will not disappear; it will only change form. Instead of surfacing as a sovereign debt and banking crisis, it will in the future appear as a North-South competitiveness and growth discrepancy crisis.

If a common treasury issuing eurobonds for all eurozone countries is not instituted, the borrowing costs of creditor and debtor countries will continue to diverge. This divergence will not be as wide as at the height of the euro crisis but it may still be substantial. This handicap for the debtor countries will make it more difficult for them to reduce their debt to GDP ratios and will require larger primary budget surpluses. As a result, they are more likely to be stuck in recession and to have lower growth rates than the creditor countries. Moreover, their firms will also have higher borrowing costs (because of the country risk) than those in creditor countries and will find it more difficult to compete.

Given this lack of a level playing field, it is probable that Europe will be divided on the basis of differential growth rates, with the northern creditor countries enjoying higher growth rates than the southern debtor ones. This will inevitably create tensions between the two groups of countries and will be damaging to European solidarity in the longer run.

Is there another way forward? It very much depends on Germany. If Germany opts for the establishment of a common treasury and for a monetary policy that takes into account the need for growth of the southern debtor economies, the euro crisis will be fully resolved. But how likely is this?

To answer this, it may be worthwhile to look briefly at the historical trajectory of Europe's progress so far. The process of European integration has been always open-ended. Two main orientations are discernible from early on. These may be dubbed "British" and "German" after the biggest countries, which most unfailingly have espoused them. The "British" orientation is towards a European common market while the "German" one is towards a European federal state.

The implications of these two views of European integration with respect to national sovereignty are clearly quite different. The first implies ceding the minimum of national sovereignty that is necessary for the operation of the common market while the second requires the abandonment of national sovereignty for the realization of the federal state.

Germany used to assert that it had no independent foreign policy, only a European one. But the German public seems at present unwilling to make concessions for the sake of federal Europe. It has made sacrifices for the cause of German reunification and then for increasing Germany's competitiveness following the adoption of the euro.

Today, after more than two decades of austerity, it is in no mood for a "transfer union" that will reward the spendthrift southerners for their profligate ways, which is how the common treasury will be portrayed by its opponents. Moreover, the German public deeply distrusts a monetary policy, which pushes up the rate of inflation in Germany. Consequently, given these prejudices, it is unlikely that the policy, which can fully resolve the eurozone crisis, will be adopted.[xxi]

8) What is Greece's future?

Time is running out for Greece. The policy of "internal devaluation" through fiscal contraction is causing a lot of pain. This is the fifth year that the economy is in recession, with GDP this year falling by 7% and the cumulative GDP reduction exceeding 20%. The income of civil servants and pensioners has been reduced by more than a quarter. In the private sector, a lot of businesses have folded up and unemployment has shot up to nearly 25 percent of the labor force and over 50 percent among the young. What is possibly worse, investment prospects are bleak and there seems to be no end in sight of this downward trajectory.

In addition, national pride is deeply hurt and prejudice, especially against Germany, is rife. Greeks are particularly resentful about accusations in the German press that they are lazy and live at the expense of the German taxpayers. This, by the way, is completely unfounded as the latest OECD statistics demonstrate: Greeks work in fact longer than most Europeans including the Germans. Moreover, they resent being used as scapegoats for the faulty design of the eurozone, for which Germany is largely responsible.

Hurt national pride tends to breed prejudice. Old memories of atrocities by the German occupation army, the huge loss in lives and the destruction inflicted to the country during the occupation, are revived and exacerbated. Germans are seen as Nazis who are trying again to subjugate Greece (and eventually the rest of Europe), only this time using economic instead of military power. In addition, the issue of war reparations, which has never been dealt with to Greece's satisfaction, inflames passions against Germany that has never paid its own debt.

The mixture of serious economic hardship and disillusionment, together with hurt pride and prejudice, leads to political polarization and a strengthening of the extremes, both left and right. The heightened social tensions can easily lead to political upheavals with catastrophic consequences for Greece's future. In these circumstances, Prof. Neumann's prediction may yet come true despite Mrs. Merkel's recent visit to Athens (on 9 October), which was meant to reassure Greece of Germany's wish to avoid a Grexit and to encourage Greeks to stay the course.

It is widely expected that if Antonis Samaras(presently presiding over a three-party coalition government) fails, the next government will be led by the neo-communist party Syriza. Syriza has consistently opposed the Memorandum and seemed to opt for the repudiation of debt obligations and Greece's exit from the Eurozone rather than accept the conditions demanded by the troika.

Nevertheless, given the unpopularity of a return to the drachma, Syriza has more recently changed its tune. Thus, in the run-up to the June elections and since then, it insists that it wants Greece to remain in the eurozone while, at the same time, redoubling its attacks on the government for being pliable to the wishes of the troika and lacking the will to renegotiate the Memorandum. In this, and possibly only this, it is in full accord with the other three opposition parties: the old Communist Party, the Independent Greeks, which is a splinter group from the right of New Democracy, and the neo-fascist Golden Dawn, which is rapidly rising in popularity.

It is clear that the most important and urgent political issue is the negotiation with the troika and, indeed, the continued stay or exit from the eurozone. Syriza wishes to draw a number of red lines (mostly regarding cuts in wages and pensions, liberalization of labor laws and, possibly above all, redundancies in the public sector) and seems to be willing to take the risk of Greece being pushed out of the eurozone. This inference is also supported by the fact that Syriza has never declared that a Greek exit would be an unmitigated disaster and has not denounced a number of voices in favor of an exit, which come from within its own ranks and sympathizers.

In all probability, a return to the drachma under Syriza would be a return to the past with a vengeance. This is because Syriza's recipe for a revival of the Greek economy is through a rise in public spending. A devaluation-inflation spiral would inevitably follow but the unholy alliance of political parties, the media and state-dependent contractors and suppliers, which are presently effectively bankrupt and clearly on a retreat, would be given a new lease of life. Public sector employment would increase but the lack of structural competitiveness, which is the crucial problem and constitutes the major impediment to the developmental prospects of the Greek economy, would not be addressed.

In fact, structural competitiveness (which is the ability to compete internationally without the aid of devaluation) would certainly deteriorate in the absence of labor market reforms. The cost of bureaucracy, which according to European Commission estimates, amounts to 6.8% of GDP (nearly twice the EU average), would probably get worse with the strengthening of the public sector unions under Syriza and this would further damage competitiveness. Privatization efforts of the inordinately large state property would certainly be abandoned and the mismanagement and exploitation of state assets by para-statist rings, often with the collusion of political parties, would continue as in the past.

The point is that the structural reforms contained in the Memorandum and the reforms needed not only in the labor market and the public administration but also in the judiciary and, arguably above all, in the financing and operation of the political parties, are ignored by Syriza, which rejects the Memorandum in its entirety. Syriza's message is that once we get rid of the Memorandum, we can reverse the reductions in civil servants' salaries and pensions and go back to the good old days. It is exactly the nostalgia for the recent past that has caused the shift of the strong public sector trade unions from PASOK to Syriza, along with the most populist elements of the socialist party's apparatus, which most benefited from the expansion of the state. The only difference from the past, according to Syriza, will be that the rich will pay more taxes.

In the rather unlikely case that Syriza does not opt for an exit from the euro, the recipe does not seem to substantially vary. The government primary deficit will need to be eliminated and this will be done, by exclusively increasing tax receipts. In this case, the rich (and only the rich) will pay a lot more taxes.

There is no question that the rich should pay their proper share of tax. The need for better collection of taxes is beyond dispute, as tax evasion is rampant. And, of course, there is a need for an equitable and operationally simple tax system, which citizens recognize as fair and, at the same time, minimizes tax collectors' corruption and does not militate against enterprise and development. But the problem is not so much that the rich don't pay taxes as that, those who can hide their income do not pay taxes.

Self-employment, especially in services, provides comparatively more opportunities to hide one's income. This applies in all countries, the more so in those lacking a highly developed sense of civic duty, while high tax rates on transactions certainly don't help. In Greece, the self-employed are the highest proportion of the labor force among all OECD countries. Also, small family-run firms with a minimal number of non-family employees constitute the vast majority of firms in the Greek economy. Moreover, trust in the government is low and, with a VAT at 23%, the buyer of a service provided by a self-employed supplier has a significant incentive not to demand a receipt. In this way, the buyer gets a discount equal to the amount of the tax and, of course, the seller does not report the transaction and does not pay income tax on it. This explains how the average income of the self-employed, from doctors to plumbers to small shopkeepers (and there are proportionately more of the latter than in any OECD country), turns out to be a small fraction of the average salaried person's income.

What can be done about this predicament? There is a great Greek success story in the international economic arena, which provides a cue to what should be done. This is international shipping, in which Greece leads the world. Greece has managed this by having a simple and stable (because it is enshrined in the Constitution) tonnage tax on ships. The amount of the due tax is reliably and unambiguously known at an instant; there is no need for detailed bookkeeping and tax accounting; no tax inspectors and corruption; no bureaucracy and meddling by the state; no grounds for political clientelism and patronage; no obstacles to enterprise and development. This tax regime obviously goes against the grain of the political elite's statist disposition and was reluctantly established not so much because of shipping's undoubtedly important contribution to the economy but because the ship-owners had (and always have) the option to easily move their seat of operations elsewhere. Consequently, not only it would be futile and counter-productive to tax ship-owners' income rather than ship tonnage, as the left wishes, but on the contrary this type of tax could be used, with equally beneficial effects, to solve the problem of taxing those who can hide their income.

A similar kind of tax, based on simple, unambiguous and readily obtainable indices of indispensable inputs to the various goods and services provided by self-employed persons and very small firms, should not be impossible to design, given the political will to do so. A simpler alternative would be the imputation of a minimum income, which is considered necessary for the provision of the various goods and services, taking into account the local cost of living. It should be noted that a tax system based on imputed values has been applied in the past, the last time about twenty years ago from the last coalition government led by a technocrat. It did not last long, given the outcry from the self-employed and small business, on the one hand, and the finance ministry and tax accountants, on the other. Thus, the allegedly "antiquated" tax, which was "not fit for a modern state", was abolished allowing the self-employed to pay practically no tax and the tax profession, both state and private, to thrive.

In conclusion, the only hope for Greece's future is that two conditions actually materialize, the first of which is beyond Greece's control. This is that Europe carries out swiftly the required reforms, establishing a common treasury and adopting appropriate fiscal and monetary policies for growth. Secondly, as regards action by Greece, the structural reforms agreed with the troika should be implemented without further delay and, most importantly, the public sector must undergo a radical overhaul, so as to reduce its size, minimize bureaucracy and promote private enterprise. This is the exact opposite of the Syriza program. The one thing about which Syriza seems to be right is that debt repayment will probably need to be renegotiated (but only following the realization of structural reforms and the restoration of competitiveness) and, preferably, linked to the performance of the Greek economy.

Endnotes

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[i] Ralph Keyes *The Wit and Wisdom of Harry S. Truman*, New York, Gramercy Books, 1999.

[ii] Martin Feldstein "EMU and International Conflict", *Foreign Affairs*, 76 (6), 1997. A lot of the pessimism expressed from different sides of the political spectrum about the prospects of the euro, was based on the fact that the euro zone clearly did not fulfill the conditions for success, as set out by the theory of optimal currency areas. See, Robert Mundell "A Theory of Optimum Currency Areas", *American Economic Review*, 51 (3), 1961.

[iii] On the same note, Winston Churchill allegedly said: "If you put two economists in a room, you get two opinions, unless one of them is Lord Keynes, in which case you get three".

[iv] Charles Wyplosz "An Open Letter to Dr Jens Weidmann", *Vox*, November 18, 2011.

[v] University of Bayreuth "The Euro (Greek) tragedy or Europe's destiny?", January 11-12, 2012.

[vi] George Soros "Does the Euro Have a Future?" *The New York Review of Books*, October 13, 2011.

vii See, Satyajit Das ""The Road to Nowhere" – Europe's Debt Crisis", *Eurointelligence*, January 9, 2012.

viii This seems to be Professor Neumann's view. A strict enforcement of the fiscal rules is not only a necessary but also a sufficient condition for the resolution of the debt crisis. If Greece cannot restore fiscal balance, it will be shown the exit from the euro zone. The temporary shock to the economy will be manageable and, in the long run, the euro zone will rest on a more stable foundation. Imbalances in productivity and growth among member states cannot be precluded but they will lead to labor flows from weak to strong economies rather than resource transfers from strong to weak ones.

ix The fiscal compact has been criticized for its fuzziness and, especially, the absence of an objective criterion for action. Automatic correction is to be effected "in the event of significant(?) observed deviations from the medium-term objective or the adjustment path towards it" unless exceptional(?) circumstances, which are not further specified, happen to prevail. It has been noted that by making a state's *structural* fiscal deficit the main operational criterion, it puts "an unmeasurable concept into the law". See, Martin Wolf "The pain in Spain will test the euro", *Financial Times*, March 7, 2012.

x Jean Monnet was the key early architect of Europe. Monnet said: "We are not forming coalitions of states, we are uniting men" on a march together toward a common European destiny.

xi Lawrence Summers "Five grim and essential lessons for world leaders", *Financial Times*, November 2, 2011. Summers' five lessons have been condensed, for economy, to the most important three lessons that are presented here. The world leaders are the Group of 20, who were meeting in Cannes at the time.

xii It is clear that, if this is true, it has important implications for the interpretation and writing of history. The rationality of the main actors cannot be taken for granted and may not guide all their actions. This means that the rational interest of the actors or "the logic of the situation" may not suffice to explain the actors' behavior at possibly crucial historical junctures. Consequently, the psychological state and motivations of the protagonists needs to be understood and taken into account, in order to accurately reconstruct historical events. But the further away in time we are from the event to be explained, the more difficult it becomes to have reliable information regarding the psychological setup of the relevant actors. As a result, the common notion that older events can be explained better than recent ones, seems to be contradicted.

There seem to be two reasons for the usual position that historical accounts of older events are more reliable than those of more recent ones, both of which relate to rationality. Firstly, there is a presupposition that there is less passion and irrational feelings about events further in the past, allowing a more rational assessment of the actors' actions. The second presupposition underlying this orthodox view is that all consequences of older events have been realized and become apparent. Then history can be interpreted as the outcome of rational (maybe even super-rational) actors who intended these consequences.

xiii Pride and especially prejudice as exhibited in the chauvinist stereotypes, such as "Greeks are lazy or liars" and "Germans are arrogant or autocratic", are clearly dangerous and can quite evidently undermine European solidarity if left unchecked. Here, the reference is to their less obvious role in clinging on dubious economic doctrines and the shaping of economic policy.

xiv Robert J. Shiller "The Great Debt Scare", *Project Syndicate,* September 23, 2011. The relevant index, from the Thomson-Reuters University of Michigan Surveys of Consumers, which reached 135 - its highest-ever point in 2000, had dropped to 88 in May 2011 and in only 4 months it further fell to 48 in September, following the months-long deadlock over the US government's debt ceiling and the stories about imminent sovereign debt default in Greece and other European states.

[xv] Adam M. Brandenburger and Barry J. Nalebuff, *Co-opetition,* New York: Doubleday, 1996.

[xvi] Kristen Allen and David Gordon Smith "Obama's Euro-Crisis Lecture is "Pitiful and Sad"", *Spiegel Online,* September 28, 2011.

[xvii] Professor Wyplosz (op. cit.) deems this to be essential despite the possible objections on the grounds of 1) legality of bailouts, 2) moral hazard and 3) independence of the ECB, all of which he considers in turn.

[xviii] "The Euro Deal: No Big Bazooka", *The Economist*, October 29, 2011. Charles Wyplosz (op. cit.) argues convincingly that German history is not an appropriate guide to the present problem, which can

be solved by the ECB providing a one-off guarantee for a minimum price of the threatened sovereign bonds.

[xix] Mario Draghi had attempted earlier this year to stabilize the situation by lending one billion euros for three years to European banks. Nevertheless, this indirect policy had three undesirable consequences when compared with a direct ECB intervention. First, it created more liquidity than was required because only a fraction of this liquidity was channeled into government bonds by the banks. Second, banks may sell off these bonds (especially if austerity-induced recession exacerbates the peripheral countries' fiscal problems) causing a new panic. Third, the easy profits provided to the banks, reduces their incentives to restructure their balance sheets. The moral hazard risk is greater for banks than it would have been for states (in the case of direct intervention) because the recent fiscal pact gives to the European Commission considerable control over state budgets. See, Paul De Grauwe "Direct ECB intervention is still the only way to end the crisis" *Financial Times*, March 13, 2012.

Moreover, it should be noted that even this indirect policy is disagreeable to Germany. Jens Weidmann in a leaked letter to the press has expressed concern about the dangers created by the ECB policy of increasing liquidity, while Jurgen Stark (a former ECB executive board member) has told a German newspaper that ECB's balance sheet "isn't just gigantic in size but also shocking in quality". See, Ambrose Evans-Pritchard "Germany's monetary doyen slams ECB's "shocking" balance sheet", *Daily Telegraph*. March 8, 2012.

[xx] The prediction by Prof. Wyplosz cannot be strictly tested any more but Wyplosz seems to have been vindicated, since the ECB presumably changed its position exactly in order to avoid a collapse of the euro.

[xxi] George Soros argues that if Germany will not lead Europe by adopting this required policy, then the only other (though inferior) alternative to continued recession for the South and eventual dissolution of the EU, is for Germany to leave the eurozone. As it is epigrammatically put, "Germany should lead or leave". See, George Soros "The tragedy of the European Union and how to resolve it" *The New York Review of Books*, September 27, 2012.