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THE PROCESS OF EUROPEAN INTEGRATION AND THE FUTURE OF EUROPE

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It is a great pleasure for me to present the 2004 Gunnar Myrdal lecture, and it is with great trepidation that I attempt to follow in his footsteps. At least on two separate occasions in America and in Asia, as an outsider, he provided keen insights into the problems facing those societies. He saw so clearly the enervating effects of racism and discrimination in America long before those problems became widely recognized by Americans themselves. Though I lived for more than six years in Europe, most of my time had been spent in one rather special part, and I undoubtedly see the problems confronting Europe, that are posed by European integration, distorted through a highly American lens. It is a special pleasure for me to give this lecture here in Geneva at the United Nations, an institution which has played such an important role in preserving peace, and an institution which has also played an important role in arguing for alternative perspectives on economic policy.

The European project was from the beginning basically a political project, based on the belief that the creation of a European community would prevent the kinds of wars that marred Europe in the first half of the twentieth century. In this objective it has been unambiguously successful. No doubt, a large part of the objective of the integration of the former eastern European countries is political, motivated by the highest aspirations of ensuring the continued development and success of these nascent democracies. But success begets greater ambitions, and today Europe is as much an economic project as it is a political project. At this moment, integration provides an occasion to reflect not only on the new challenges posed but also on the direction of the entire enterprise. As Europe faces basic constitutional questions, the relations between politics and economics, including the institutional structures for decision-making and constitutional restrictions on national governments, cannot be avoided.

Economic integration is, of course, not an end in itself. It is a means to an end. The end is equitable and sustainable increases in living standards. In pursuing this end, we must not compromise other fundamental values, such as our commitment to democratic processes. Such terms may mean different things to different people, but this much is clear: democracy requires elections, but it means more than that. Equitable development means that the poor share the fruits of the growth of the prosperity that economic integration brings. And yet it means still more than that too. At the very least, sustainability means that gains in incomes of this generation from this integration not be at the expense of future generations by compromising the environment; or that the gains of one group not be at the expense of others, and not be so out of proportion that this threatens social sustainability and cohesion.

In a variety of ways, Europe has made its commitments to these values clear. The social chapter is designed to ensure that the benefits of growth not be achieved through a race to the bottom. Europe has stood strong behind the rule of law and basic human rights, as evidenced by its opposition to capital punishment and support for the International Criminal Court. Its commitment to the environment is being evidenced by its willingness to proceed with fulfilling the mandates of the Kyoto Agreement, even though the world's largest polluter refuses to do its fair share to preserve the global environment.

In the limited time available, I want to take up five areas which will be affected by the expansion of Europe and integration of the new countries.

The first concerns the basic economic model, which seems to underline much of the discussions concerning economic policy today. What worries me most is not that the model is flawed, as it is

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based neither on theory nor evidence, but rather on a set of ideologies and interests. What worries me most is that there is a risk of incorporating policies based on that model into the Constitution of Europe, which is a set of institutions and rules that cannot be easily changed.

The second concern is that insufficient attention is being paid to what I view as a basic right, reflected in the ILO's commitment to the right to decent work.

Thirdly, I want to share with you the worry that if the rights of workers have gotten insufficient attention, the rights of corporations have received excessive protection. A successful Europe will have to deal with the problems of corporate governance.

The fourth concerns democratic processes. Elsewhere, I have written extensively about the democratic failures of the international economic institutions. The diversity of an expanded Europe makes it all the more imperative that Europe be based on strong democratic institutions, and yet that same diversity makes the challenge of doing so more difficult.

Finally, social democracy has always been based on universal ideals. The comparison between foreign assistance provided by Europe to the developing countries and that of the United States does not paint a flattering picture of America. With the end of the cold war, there is a new geopolitical reality which has only gradually been grasped. As I have said before, Europe began as a project designed to preserve peace in Europe and the world. Today, a half century after the beginning of this project, it must be redesigned if it is to continue to fulfil that mission.

The basic economic model

I am going to begin with a discussion of the economic model that underlies much of the thinking behind current policies which underlay much of Europe's current economic agenda. Economics often dominates discourse on European integration. Today, there is worry about the stalled growth in Europe. Two hypotheses are put forward: lack of aggregate demand and structural rigidities.[1] European politicians – including monetary authorities – love to talk about structural rigidities, what should be done about them, and what is being done. Around the world, central banks say, when the economy is performing below par, that the problem is with the fiscal authorities and microeconomics, whereas the fiscal authorities say that the problem is with monetary policy. But what they all agree on is that somebody else is to blame.

Europe did not suddenly become more rigid a few years ago; if anything, Europe has become more flexible. The source of the current malaise is the lack of aggregate demand, resulting in part from an excessively rigid macroeconomic framework; the Stability and Growth Pact, that ensures neither stability nor growth, and which restricts the ability to use countercyclical fiscal policy to stabilize the economy; and a European Central Bank, which focuses excessively on inflation and pays insufficient attention either to other macroeconomic variables, like the exchange rate, or the more fundamental concerns of growth and employment. It is fighting the problems of the last century and not those of the current one, which are more centred around the lack of aggregate demand and insufficient growth and deflation than on excessive aggregate demand and inflation.

There are perhaps two justifications for arguing that monetary policies should focus exclusively on inflation. Nobel Prize laureate Jan Tinbergen, one of Europe's great economists, put forward the hypothesis that one should match instruments with objectives. We now know that, especially in the context of uncertainty – both about where the economy is going and the effectiveness of various instruments – we need to use all the instruments we have in a coordinated way. The kind of separability underlining Tinbergen's analysis (where, if there are n instruments and n objectives, each instrument could be assigned a particular objective)[2] is, in general, not valid.

For all the criticism of recent macroeconomic policy in America, this much can be said for it: at least the Federal Reserve has a *mandate* to focus not only on inflation but also on growth and employment.

The second possible defence for the exclusive focus on inflation of the European Central Bank is the belief that low inflation is necessary and sufficient for strong economic performance. If only the central bank ensures price stability, so the argument goes, and it does not otherwise interfere with the workings of the market economy, then the market economy will perform as it should, with low unemployment and high growth. Indeed, it is the same doctrine that underlies the emphasis on structural reforms, which are often an euphemism for weakening job protection of workers. To be sure, such protections can be excessive, and when they are, unemployment may be higher than it otherwise would be,[3] though growth will not necessarily be lower than it otherwise would be, unless the size of the rigidities is in fact increasing. But in fact, there are a variety of reasons why market economies may not work well – at least in the sense that there may be persistent unemployment – even without government interventions. The theory of asymmetric information has helped explain why capital, product and labour markets often work markedly differently than envisioned in perfect market models – the kind of models which often underlie the market fundamentalism approach. One of the most important results of our research was a re-examination of perhaps the most fundamental issue in modern economics, what in formal literature is referred to as the "fundamental theorem of welfare economics" and was known as Adam Smith's invisible hand. This theorem argued that markets, or more precisely the pursuit of self-interest, led, as if by an invisible hand, to economic efficiency, or more precisely, to use economics jargon, to Pareto-efficiency. Almost two decades ago, Bruce Greenwald and I showed that when information is imperfect and markets are incomplete – that is, essentially always – the economy is *not* efficient (or more precisely is not Pareto-efficient).[4]

In other words, what this result argued is that the reason the invisible hand often seems invisible is because it is not there. And I tried to argue, in my most recent book on the roaring 1990s, that these problems were evidenced in what happened in that decade in the United States.[5] The pursuit of greed – which is another name for self-interest – by America's accountants, investment banks and CEOs, did not enhance the general interest, even if it did enhance their profits temporarily. This theorem not only undermines the presumption underlying the beliefs in unfettered markets, it shows that market failures are pervasive in the economy, going well beyond the problems of externalities and public goods upon which economists had previously focused. As if to bear witness to the relevance of this theorem, the consequences of the conflicts of interest that marked the roaring 1990s in the United States amply demonstrate that the greed of corporate executives – their unbridled and unchecked pursuit of their own self-interest – neither served well their companies, shareholders and workers, nor the broader economy.

These market failures pale, of course, in comparison with those associated with the Great Depression, the memory of which seems to have faded. The cost of even the recent recession in the United States, widely described as mild, has been great: a cumulative loss in output in the economy relative to its potential between 2001 and 2004 of over one trillion dollars.[6]

The focus on inflation is an example of a more general problem that has characterized so much of the European economic project, which has been based on a set of economic doctrines that have increasingly been called into question. Among these are the following:

- Price stabilization leads to faster economic growth (the proposition I referred to earlier);
- Trade liberalization leads to increased economic efficiency and higher economic growth and welfare;
- Liberalization always and inevitably increases economic efficiency.

Let me return to the first of these propositions. There is now widespread acceptance that so long as inflation remains low or moderate, there is no significant link between the level of inflation and the rate of growth. Recent theoretical research by Akerlof and his co-authors[7] has in fact shown that pushing inflation too low lowers efficiency. In my own works with Bruce Greenwald, we have shown how deflation, or even unanticipated disinflation, can have large negative effects on the economy.[8] Not only can price rigidities give rise to problems, but so too can excessive price flexibility. Indeed, cross-country statistical analysis not only fails to demonstrate that countries with independent central banks which focus on inflation grow faster or have lower unemployment or higher real wages, but also that, below a critical threshold, lower inflation does not lead to faster economic growth, and that greater wage flexibility does not lead to greater economic stability.

Again, economic theory has long shown that trade liberalization does lead to increased economic efficiency (though not necessarily faster economic growth) *if markets are perfect*; but if, for instance, risk markets are imperfect – as they are – or if there is significant unemployment – as there is in many countries, especially developing countries – then trade liberalization may actually be Pareto-inferior.[9]

To buttress these points, Dani Rodrik and Francisco Rodriguez[10] convincingly showed that empirical studies attempting to establish that trade liberalization leads to faster growth are deeply flawed.

Preliminary research underway at Columbia University suggests that for economies with high unemployment or weak safety nets, trade liberalization has not in fact produced the promised results.

The case for capital market liberalization, which the IMF pushed so strongly, is even more questionable. The countries with the fastest economic growth – India and China – have not fully liberalized their capital markets, and it is their decision not to do so that at least partly accounts for their greater stability, especially in the period of the global financial crisis.

Europe itself grew faster in the era before capital market liberalization than it has since. Today, even the IMF recognizes that the evidence suggests that capital market liberalization neither increases stability nor growth. While the IMF seems bewildered by the results, since it is counter to the perfect markets model, it is perfectly understandable within more reasonable theoretical frameworks. Even in the simplest life-cycle model, capital market liberalization can be shown to give rise to greater volatility of consumption and lower social welfare.

The case for privatization or deregulation rests on no firmer grounds than the case for trade liberalization, as I showed in my earlier work with David Sappington.[11] The experiences in the United Kingdom with railroad privatization, or in California or the north-east with electricity deregulation, are hardly comforting. And while in each case, defenders of privatization and deregulation claim that the problem was flawed privatization or flawed deregulation, they have not responded to the fundamental underlying problems. It is, at best, hard to price a public good like electricity reliability, and even harder to devise price systems which make electricity firms pay the full cost of the externalities generated by their actions – the costs imposed by their mistakes on others.

Presumably, many of the mistakes in the design of deregulation and privatization will eventually become all too apparent, and hopefully they will be corrected. The costs in the meanwhile may of course be enormous. But what should be of even greater concern is that it may be particularly difficult to reverse some of the decisions and to undo the damage when current flawed perspectives are incorporated into constitutional provisions.[12]

The European Central Bank illustrates the point. Later, I shall discuss the issue of democratic accountability. Here, I note only its exclusive focus on inflation with a seeming disregard for the exchange rate, and its continued insistence on the need for structural reform. Of course, in every country there is the potential for structural reforms that would improve economic efficiency. But the question is are these the root of the problem, and would the structural reforms being advocated solve the problem. Note that the euro has increased its value by more than 50 per cent against the dollar in a relatively short time. To offset this would require a productivity increase of 50 per cent. Even the most ardent advocates of reform cannot cite any instance in which such reforms had effects on overall productivity even approaching this level over the period of a decade. For Europe to rest its hope that such reforms – even were they politically accepted – would soon get it out of its current malaise is simply not credible.

The right to work

Let me turn now to the second concern, which is the right to work. Perhaps the most fundamental problem with an economic framework focusing exclusively on inflation is that it does not give sufficient – or any – importance to employment. We should begin with the view that the right to decent work is a basic human right. There is little more enervating to an individual's sense of worth than the lack of a job and the dependency on others, whether it is the family or the state. We know too that societies with lower levels of unemployment are likely to have less poverty, lower levels of violence, better health and other positive social indicators. Not only is unemployment a major waste of resources, but also low unemployment allows individuals to undertake greater risks, and risk-taking is at the heart of the success of a modern, innovative economy. Critics of the welfare state fail to note that although Sweden may well have adjusted its welfare state in recent years, it still provides far higher levels of social protection than do many other countries in Europe, and certainly more than America. Yet Sweden has participated in the new economy to a greater extent than almost any other country in Europe, and its overall performance has been among the best. And yet it has also performed better on a broad array of social indicators. In the perspective just put forward, this is no accident. There are trade-offs, and economic policies focusing exclusively on inflation would inevitably give rise to unemployment.

The problem with the European Central Bank is compounded by the Stability and Growth Pact. At least since Keynes, we have recognized that when an economy goes into an economic downturn, well-designed countercyclical fiscal (and monetary) policies entailing temporary deficits can be important instruments for restoring the economy's strength. To be sure, one must be aware of the dangers so amply illustrated by President Bush's economic programme, in which poorly designed tax cuts provide only very limited stimulus to the economy but generate huge deficits. Bush has shown that huge deficits *may* have very little effect. When I was in the Clinton Administration, we used an American expression, "to maximize the bang for the buck", meaning to maximize the amount of stimulus one got per dollar of deficit. What President Bush has been trying to do is just the opposite: minimize the bang for the buck, by giving as big a tax cut for the rich as he can. While we can hope for a more flexible interpretation of the Stability and Growth Pact and for better countercyclical frameworks providing more flexibility to European fiscal policy, we should recognize that embedding a particular set of policies fashionable at the time into a hard-to-change constitutional framework is a fundamental mistake. The flaws are already becoming apparent, and dissatisfaction will almost surely grow over time. Putting into the Constitution rigid institutional frameworks based on passing ideas, even when they may have been well designed to address the problems of the past, may well impede the ability of the economy to address the problems of the future. Economics is replete with such passing fads and fashions; monetarism is one, and today, throughout the world, people can be glad that those ideas, while followed sometimes at great costs by central banks throughout the world, are no longer at the centre of monetary policy. While I was serving in the Clinton Administration, we succeeded in rejecting a constitutional change that was being pushed by many conservatives: a balanced budget amendment to the constitution which would have circumscribed the use of countercyclical fiscal policy, just as the Growth and Stability Pact does. Less than eight years later, there was almost universal consensus that it would have been a very bad idea to have put that particular view into the Constitution.

The integration of the new countries, together with globalization, puts some urgency into the re-examination of this institutional structure. The neoclassical model, as flawed as it may be for policy purposes, provides some guidance for thinking about the nature of the problem. Wage disparities between skilled workers in some of the eastern European countries and those in Germany or France are enormous, and disparities between the wages of skilled workers in Europe and India are even larger. Samuelson's factor price equalization theorem says that if technology is the same, then free trade results in the equalization of factor prices across countries; that is, wages of skilled workers in India and Europe should be the same. The implication for Europe should be obvious, and the decreases in skilled wages and the economic disturbances would be enormous. Globalization, even if it has not resulted in a full transfer of technology and completely free trade, constitutes a significant move in the direction that I just described, and the factor price equalization theorem predicts a corresponding move in the direction of factor price equalization. If that is the case, the model on which European integration is based argues that we should expect skilled wages in Europe to fall, perhaps dramatically.

Not long ago, advocates of free trade provided assurance to those worried about where all this was leading. They said, "Don't worry, increase the skills of your labour force, shift to the service sector and you will do fine". Implicitly, they assumed that trade and services would be limited, and that, accordingly, even if skilled manufacturing jobs moved to China, there would be a demand for skilled service sector jobs. But all of this has been changed by the Internet, which has allowed outsourcing of services in a way that was unthinkable just a little while ago. While there are no reliable estimates of the amount of jobs outsourced, some put the number at under 300,000 for the United States. For an economy which has failed to create jobs for three years, even that number can be deeply worrying. But the real concern is the potential for outsourcing, and some outsourcing advocates have put the number as large as half of other service sector jobs. What is distinctive about much of the outsourcing is how independent the firms in developing countries are from their overall environment. Their success depends mostly on factors that are under their own control, provided the government does not excessively interfere with their activities.

The neoclassical model says still, “Don’t worry, we can maintain full employment if only we allow labour market flexibility” (i.e. a quick decrease in skill wages by, say, 75 per cent); if we are lucky, perhaps only a 50 per cent decline in wages will be required. Of course, if we do not have the necessary wage adjustments, we can expect high levels of unemployment.

In short, either way, the neoclassical model, the model that provides the basis for the liberalization agenda, suggests that there may be massive adjustments and massive adjustment costs. Even if some, for instance, the owners of capital, are better off as a result of falling wages, many, perhaps most, will be worse off – and many dramatically so. If we try to compensate those who are worse off, we can no longer be assured that trade liberalization is overall welfare-enhancing so long as there are costs associated with providing the compensation required to offset the adverse redistribution that results. (Today, there is a recognition that economists’ view that such redistributions could occur costlessly through lump-sum transfers is simply wrong; ironically, many of the conservatives who are the strongest advocates of globalization and integration are also those who emphasize most the costs of redistributive taxation.) It is perhaps only because we are still far from the neoclassical model that we have not had these dire results; but the advocates of the new liberal reforms would have us believe that those reforms provide the ideal to which we should be aspiring. If we could only attain that ideal, they think, all will be well. Yet this analysis suggests the contrary.

As it turns out, the shock to the system posed by integration may be far less than that posed by globalization more generally. The adjustments required to respond to integration may put Europe in a better position to respond to the globalization shocks. This would be the case if Europe retains and develops further the safety nets and adjustment programmes. Some of the reforms in Europe are directed at making the economy more flexible in ways which should make wage adjustment and labour reallocation easier. But some of the reforms in Europe are directed at weakening the safety nets, which would make the adjustments more painful to many. The combination may mean globalization would impose unacceptable tensions on society, with social and political consequences that are at the very least disturbing.

Corporate governance

Let me now turn to the third issue, that concerning corporate governance. While rigidities and market failures in the labour market are widely discussed, the market failures in the corporate sector have not received sufficient attention. While I do not have time to discuss all of these, I would at least like to spend a few minutes on them. The problems of corporate governance have long been recognized. At the end of the nineteenth century, Alfred Marshall, one of the great economists of the time, was once asked to comment on the achievements of economics during the nineteenth century and the main problem facing the twentieth century. As he put it, the achievements were easy to describe. The main problem was that of “corporate governance”. He did not use those words, but the question was how do large corporations work.

We have a well-defined theory of small firms: I own a firm, I increase the profits, I get to keep the profits. But, in a fundamental sense, nobody “owns” large firms. That is to say, there are thousands, millions of owners. The managers own a small fraction. Costs of information make delegation of decision-making to managers inevitable, and give rise to agency problems. The incentives of managers do not necessarily coincide with those of the shareholders, and even the best-designed incentive pay systems only partially align the incentives. The manager is an employee of the firm, of the shareholders, and like any employee he should be monitored. But there is a public good problem. If a single shareholder, or even a group of shareholders, monitors the managers, and the performance of the firm improves, all shareholders, whether they have contributed to the cost of the monitoring or not, benefit. What then provides the incentive for anyone to monitor? And what makes managers act in ways which maximize the value of the firm? Alfred Marshall posed this question over 100 years ago, and he recognized that we have no good theory of the modern corporation. Interestingly, he turned to sociology. He seemed to suggest that the reason that corporations worked so well in Britain at the time was that in boys’ boarding schools of the time, where Britain’s corporate and political leaders were being trained, the students were taught to respect “God, King, country and company”. They were taught to do what is best for your company as children, and good English boys continued to do that after they grew up. That was, of course, well before the more recent corporate scandals.

The central point that I tried to raise in my book on the roaring 1990s is that during the 1990s the system of corporate governance, the system of checks and balances, got out of hand. For instance, one part of the system of checks and balances is accounting. Accounting is important because it provides information. If you do not have good information, the market system cannot work well. The market system is based on price signals. When prices are high, suppliers produce more; if prices are not based on good information, they will be giving the wrong signals to the economy, leading to a distorted allocation of resources. That is why accounting is so important.

When I was at the Council of Economic Advisors, we had a major debate about accounting reform. No one could understand why the Council of Economic Advisors was so interested in accounting. The only profession that is usually viewed as more boring than economics is accounting. But the reason was very simple. Accounting provides a framework for looking at information. It enables investors to make sense of the information that is being provided, to judge prospects of future returns, which is the basis of judgments about how additional resources should be allocated.

We focused at the time on stock options for CEOs and other corporate executives. The stock options were marvellous because they gave CEOs a lot of money. And what was wonderful about them is that while the CEOs knew they were getting a great deal, it was not clear who was giving it to them. It was like money from heaven. They were getting something, but seemingly no one had to give it to them. But of course, we all understand the basic principles of the conservation of matter – the CEOs cannot get something without somebody giving it to them.

What the shareholders did not fully realize was that what the CEOs were getting was coming out of their pockets; their shares were being diluted. They used to own 100 per cent of the company; if the CEOs now got 20 per cent, they owned 80 per cent, so their shares were worth less. But they did not know it because the accounting frameworks did not reveal it. "Oh", the CEO's would say, "do not worry, it is in the footnotes." If you spent your time reading the footnotes and figuring out what they meant, you would not have time left over to work for a living, and you would not have any money to invest in the company. We proposed a reform, saying that we should have better accounting systems so that people could see what is going on. The United States Treasury opposed it. Why? They said it weakens stock market prices. We thought they were giving an argument for reform. They were saying that if people only knew how much the value of their shares was being diluted by the stock options being issued – and it was enormous – they would pay less for the shares. That was exactly our argument. We thought that this was an argument *for* reform. But they said that it was an argument *against* reform. Of course, the reason was again pretty obvious: we both agreed that better information would mean that stock prices would go down. There was a party, a party that was just beginning in the mid-1990s, and nobody likes to be a party pooper, especially when there are a lot of your friends that are getting a lot of the party favours.

At the Council of Economic Advisors, our view was that *eventually* the information would get revealed. But if you develop accounting frameworks that allow accurate information to be hidden, you postpone that day, and in the meanwhile you risk getting a bubble. Failure to recognize the value of dilution means that stock prices are too high. Eventually, every bubble comes to an end; the stock market crashes, and when it crashes it is bad for the economy. The economy suffers in the boom from misallocated investment; and it suffers after the crash, since crashes almost inevitably are accompanied by downturns and recessions. The larger the boom, the larger the crash, the deeper and longer the ensuing downturn. That is precisely what has happened (though, to be sure, macro-mismanagement after the crash contributed to the depth and duration of the slowdown).

Eventually people figured it out. The value of the dilution was not small: up to 15, 20 and, in some cases, 30 per cent of the value of the company. But what was even worse about the stock options was that they provided the CEOs with distorted incentives. They had incentives to increase their share price. It is easier to increase the share price by giving distorted information than by coming up with good projects, so they figured out ways of doing so with the help of the banks and the accountants. The accountants used to do accounting. That was a long time ago. In the 1980s and 1990s, accountants found out that they could make more money being consultants. With most of their money coming from consulting, they had a real conflict of interest. Were they going to be tough on a firm that was cheating a little bit on its accounts if it meant that they lost a huge consulting contract? The answer was obviously no. Economics believes in incentives, and both the CEOs and the accountants had distorted incentives. Accounting is part of the corporate governance structure, the set of rules and institutions which help ensure that corporations "behave well" and allocate resources efficiently. The numbers provided by accountants are an important part of the checks and balances on the CEOs. In the 1990s, the systems of checks and balances involving investment and commercial banks as well as accountants were all undermined.

I emphasize these problems of corporate governance, because I think the subject has been underemphasized in recent discussions in Europe. While Europe did not have as many scandals as the United States, some of those that it has had have been almost as dramatic. The scandals that have occurred highlight the fact that the array of diseases affecting corporate governance goes easily across borders. There is no visa that they need to come into Europe. In fact the evidence shows that there is sometimes in corporate governance a race to the bottom; there are some incentives for each country to imitate the worst practices elsewhere.

Corporate governance has been a particular problem is some of the countries now being integrated into Europe. Europe as a whole will benefit if the best practices become universal and it will suffer if the worst practices spread. Hopefully, as integration proceeds, there will be convergence towards the best practices.

The democratic deficit

I want to turn to the fourth issue, and that is the democratic deficit. As I have said at the beginning, the European project is a democratic project, and democracy is more than just elections. It involves participation and deliberation. Democracy within Europe requires meaningful democracy in each country. There are several real challenges, and given the limitations on my time, I want to talk about three of them very quickly.

The first is that of reconciling expertise with democratic accountability. One of the arguments that has been put forward for an independent central bank is that monetary policy is too important to leave to democracy. It is a very peculiar argument. If that is true about monetary policy, what about taxation policy? The United States has shown that politicians can be very irresponsible on taxation. And the technical issues in assessing the true incidence of taxation are very complicated, well beyond the training of almost all politicians. Does that mean we want to have an independent taxation authority? What about expenditure? Where do we stop on this agenda? Is monetary policy different from taxation, expenditure or any other aspect of economic policy? Yet Europe has been sold on the idea that an independent central bank is important, and that it leads to better economic performance. The evidence is not compelling. An independent central bank focusing on inflation does lead to lower inflation. If it did not do that, then you really would throw out your central bankers. But the objective of economic policy should be higher real incomes, stronger growth, lower unemployment. An independent central bank does not lead to faster growth, higher real wages or lower unemployment.

The issue of independence is also often confused with issues of representativeness and with what should be the central banks' mandate. One can have an independent central bank, but a more representative central bank. I said earlier that there were trade-offs: more inflation, less inflation, more unemployment, less unemployment. When there are trade-offs, there are political choices; political choices cannot be delegated to technocrats. One can delegate to technocrats the task of designing the best software for clearing checks. I do not think any of us think of that as something we care about, other than that it be done well. There is no political content in such a decision. But as citizens, we do care about the trade-offs between inflation and unemployment. One cannot tell some technocrat to do what *he* thinks is best, when the decision involves different groups being affected in different ways. Low inflation benefits financial markets, while low unemployment benefits workers. Why should the responsibility of making that choice be delegated to a technocrat? The outcome will reflect the views and preferences of the technocrat, not necessarily those of society more generally. If you were to delegate this to "independent" representatives of labour unions, you would get a different answer than if you were to delegate it to independent representatives of financial markets, or even to independent representatives of the business community. Independence does not require non-representativeness. But almost all the central banks are not only independent, they are also non-representative. One of the European central banks, at least, has representatives from labour, to make sure that the voices of workers, of those who would be thrown out of jobs because of restrictive monetary policy, are heard.

A number of countries of Latin America have recognized that representatives of the financial markets reflect special interests, and thus impose restrictions on their dominance of central bank boards. They look for more neutral people to serve on their central bank boards.

What is so ironic about this is that macroeconomic performance is the most important factor in determining the outcome of elections, yet governments now do not have control over perhaps the most important variable determining that macroeconomic performance, monetary policy. They are being held accountable for something for which they are not responsible. They may be blamed for a recession when they cannot do anything about it. So we have a system with a lack of democratic accountability for those who do make the decisions, while politicians face accountability for things for which they are not responsible.

The second point, which is related, is that there are a whole variety of other areas in which society faces a multiplicity of choices. After the fall of the Berlin wall, it was recognized that the two extremes, of complete government control of the economy or of laissez-faire (no government involvement in the economy at all), do not work. That is why there is increasing focus on a *third way*, somewhere between these two extremes. There is not a single third way; there are many third ways and many important areas of choice. The Swedish model is different from the American model, the French model is different from the German model – each of these countries has a different model. One of the problems is that there may be an attempt within European integration to force a single model on all countries. The central question which needs to be addressed is, what is the *minimum* degree of harmonization that is required that would enable Europe to work together? If one pursues harmonization excessively, one reduces the degree of diversity, the scope of local control and adaptation to local circumstances. There are an enormous number of *efficient* alternatives, even in areas involving highly technical issues. Just as macroeconomic policy cannot, or at least should not, be left to technocrats, neither should matters of corporate governance, the design of bankruptcy regimes or the construction of social safety nets be left to technocrats. Too often technocrats do not recognize this, and they try to persuade others that these matters should be delegated to them. The worry is that in many areas they have been successful. What struck me was, having come to the World Bank from the Clinton Administration, when I went into discussions with the IMF, they often argued for positions that were the opposite of what I had fought for during four years inside the Clinton Administration. I had to ask myself had I been wrong for four years. Had I let politics sway my economic judgment? Or was the IMF wrong? The real point is not whether I was wrong or they were wrong; the real point is that there are choices. And while we may debate whether their answer was right or wrong in the circumstances of each country, it is clear that they were wrong in ignoring the trade-offs, in recognizing that there were choices that needed to be made, not by technocrats but through the political process. One worries today in Europe whether too much power has been delegated to technocrats in areas which should be the domain of political decision-making.

Let me give one example. When I was in the Clinton Administration, we had a very heated debate about bankruptcy reform, a seemingly very technical issue. Most economists do not spend much time analysing the economic consequences of alternative bankruptcy codes, but modern capitalism could not have developed without bankruptcy,[13] and the design of the bankruptcy systems affects the relative balance of creditor and debtor. There are, as a result, significant consequences for society. It was, accordingly, not surprising that the political debate over bankruptcy reform was so heated.

There was an ad for credit cards in the United States from one of the major commercial banks that said "qualified at birth". The ad seemed to suggest that at birth a child is eligible to get a credit card. They hoped the child would get the card and spend without constraint, or at least up to the credit limit. Under the kind of bankruptcy law that the commercial banks seemed to advocate, the child would be indebted to the bank for the rest of his life, especially with overdue balances cumulating interest and penalties at usurious rates. But many Americans thought that the problem of a 14-year-old with excessive credit card debt should be placed squarely on the shoulders of the bank that issued the credit card. The kid should be able to easily discharge the debt; he should not have to spend the rest of his life paying off his debt. A debtor-friendly bankruptcy law would help ensure that lenders did due diligence in making credit available; saying that one is "qualified at birth" does not represent due diligence.

During the East Asia crisis, the IMF recognized the importance of having a good bankruptcy law; but from their discussions of what this entailed, no one would ever have known that it was a highly political issue. They acted as if one could delegate it to technocrats, particularly technocrats hired by or representing the interests of commercial banks.

The real danger is that in the process of European integration, harmonization will be pushed too far, and too much responsibility for the design of institutions and legal frameworks will be given to technocrats. There is no reason that, for instance, every country must come to the same answer on the appropriate balance between creditor and debtor interests. There are some areas in which a high degree of harmonization is necessary, but others in which it is not. There are many areas in which there is no reason that a single view should prevail. Delegating to technocrats decisions in which there are important trade-offs among different groups, decisions which are fundamentally political in nature, undermines democratic processes.

There is one area in which I particularly want to express concern. Europe is committed to democracy, but there is more to democracy than just periodic elections. Meaningful democracy requires an informed citizenry, and there are increasing worries in some countries about the extent of media concentration. If six of the seven television stations in a country are controlled by one person, there is no real media diversity; if there is a heavy concentration of TV and other media, then the dangers of lack of diversity are even greater. The media play an important role as part of the checks and balances in democracy, but without adequate media diversity they cannot play that role. My work in economics has focused on the issue of asymmetric and imperfect information, but problems of asymmetric and imperfect information are even more important in political processes than in economic processes, as the events of the past year over Iraq have so amply demonstrated. It seems to me extremely important that there be strong regulations preventing excessive media concentration. The worry is not just that concentrated economic power will result in higher prices for consumers (or higher advertising rates); the worry is more for the consequences for democracy. The real problem with media concentration is that "media power" can push a particular set of (economic) policies based neither on theory nor evidence, a set of policies that reflect particular interests, rather than the interests of a broad spectrum of the society.

Europe in a global context

My final set of remarks involves a brief discussion of Europe in a global context. As I said, Europe began as a peace project and then became an economic project. The hope was that closer economic interdependence would lock the countries into each other in a way that would make conflict too costly. Moreover, closer interaction, it was hoped, would build bridges of peace. Those hopes, I think, were well founded. But somewhere along the way, what should have been a means to an end became an end in itself. And the economic project was captured by those with a particular ideology and a particular set of interests. The story of how that happened needs to be told, but would take us beyond the scope of this lecture.

If Europe has been overly ambitious in its economics, it has been insufficiently ambitious in its peace project. With the end of the cold war, the question of defence arrangements needs to be re-examined no less than the economic questions which have been forced upon Europe by integration. An arrangement which promoted geopolitical stability in a world in which there were two centres of power may not make sense in a world in which there is a single superpower. Even if that particular power was exercising its power in a way for which there was consensus support, the fact is that human frailty – the fact that people make mistakes – suggests it is important to have a multiplicity of centres of power. Long-standing principles of checks and balances suggest the need for fundamental change.

There is an old adage "power corrupts and absolute power corrupts absolutely". The United States asks the world to rely on its intelligence, unchecked and unverified, to make a crucial set of life and death decisions, e.g. the decision to go to war in Iraq. America's Congress has proved itself once again unable to check a President determined to go to war.[14] We know now that the previous information which was asserted with such certainty should have been presented with far more caution. The jury may be out on whether it was incompetence or deception, but the political lesson is the same: the need for Europe to assume a greater role as part of a global system of checks and balances. This in turn requires a re-examination of institutional structures of the defence arrangements. Can Europe provide the requisite check on unbridled American power best by acting in a fragmented way within NATO? Or would some form of a European Defence Force provide greater cohesiveness, enabling Europe to express a collective voice – a voice of reason – especially important in a world in which the world's only superpower has not only openly committed itself to unilateralism, American exceptionalism and pre-emptive warfare, but has shown a willingness to ignore the principles underlying an international rule of law as well as the opinions of those who differ from its positions?

Concluding remarks

At one level, the size of the new economies relative to the size of the old suggests that, at least in the short run, for the old economies this may be a non-event, even if the anticipation of accession has had a profound effect on the countries about to join. But the effects on labour markets may not be so small; adjustments may not be so easy, and the problems may be compounded by the challenges posed by globalization.

As I look at Europe, what worries me most is that the institutional structures already adopted may make the adjustments more difficult and more costly, both to the society as a whole and, especially, to workers. It is a structure which places less emphasis on employment than it should, and seems less concerned with the role of social solidarity and social justice than it should. Just at a time when there may be greater need for social safety nets, some countries are discussing weakening them. I worry when I hear more discussions about restructuring than about social justice, when there is more focus on particular means rather than broader ends. I worry especially when the particular means are based more on ideology and interests than on economic science, and when a particular set of currently fashionable doctrines is embedded into hard-to-change institutional and constitutional structures. I worry even more when decisions which should be made by political processes are delegated to technocrats, when there are excessive demands for harmonization that undermine the ability of different countries to design institutions which reflect their own values and circumstances, and when there is insufficient direct accountability on the part of some of the key decision-making institutions.

As an outsider, I see the integration of the former communist countries as an act motivated by the highest principles and values. As Europe approaches enlargement, it is fitting that Europeans are thinking about its economic and political institutions, the consequences of its institutions and policies, and how those institutions should be modified. Inevitably, the expansion of Europe will require important changes in its institutions.

As it goes about thinking about its new constitution, it is important that Europe ask, is it consistent with its long-standing values and principles, with promoting sustainable democratic and egalitarian growth? Has it locked into place institutions, rules and policies which, whether right or wrong, should be left to future generations to decide for themselves? Is it putting into its constitution policies which are based on currently fashionable economic doctrines, ideas which are already questioned in some quarters and which may go out of fashion in the future? Is it putting into its constitution policies which are designed to address problems that Europe faces today – or faced yesterday – but which will make it difficult for Europe to respond to the problems and challenges of tomorrow?

I hope my remarks today may make some contribution to the discussion on these issues which are of such vital concern, not only for the future well-being of Europe, but of the entire world.

Geneva, 11 February 2004

Notes

[1] A third problem is often noted: the inadequacy of what may be termed the system of innovation. As in the case of structural problems, there is undoubtedly room for improvement. The issue, however, is whether something suddenly happened around 2001 that can account for the seemingly sudden change in performance.

[2] J. Tinbergen, *Economic Policy: Principles and Design* (Amsterdam, North Holland, 1956).

[3] Although this will not necessarily be the case; in competitive labour markets, the costs of these restrictions will be reflected in lower real wages. J. Stiglitz, "Taxation, public policy and the dynamics of unemployment", *International Tax and Public Finance*, Vol. 6, Issue 3, August 1999, pp. 239-262.

[4] B. Greenwald and J. Stiglitz, "Externalities in economies with imperfect information and incomplete markets", *Quarterly Journal of Economics*, Vol. 101, Issue 2, May 1986, pp. 229-264.

[5] J. Stiglitz, *The Roaring Nineties, A New History of the World's Most Prosperous Decade* (New York, W.W. Norton, 2003).

[6] Assuming a potential growth of the economy of 3.5 per cent, the cumulative loss in output is approximately $1.7 trillion.

[7] G. Akerlof, W. Dickens and G. Perry, "Near-rational wage and price setting and the optimal rates of inflation and unemployment", *Brookings Papers on Economic Activity*, 1 (Washington, D.C.), 2000.

[8] "Financial market imperfections and business cycles", *Quarterly Journal of Economics*, Vol. 108, Issue 1, February 1993, pp. 77-114.

[9] See, for instance, D. Newbery and J. Stiglitz, "Pareto inferior trade", *Review of Economic Studies*, Vol. 51, Issue 1, January 1984, pp. 1-12.

[10] D. Rodrik and F. Rodriguez, "Trade policy and economic growth: a skeptic's guide to the cross-national evidence", in B. Bernanke and K. Rogoff (eds.), *Macroeconomics Annual 2000* (Cambridge, MA, MIT Press for NBER, 2001).

[11] D. Sappington and J. Stiglitz, "Privatization, information and incentives", *Journal of Policy Analysis and Management*, Vol. 6, Issue 4, Summer 1987, pp. 567-581 and "Information and regulation", in E. Bailey (ed.), *Public Regulation* (London, MIT Press, 1987), pp. 3-43.

[12] There are other examples. Historically, governments have used a variety of "industrial policies" to promote the development of new industries. (In the United States, today, this is typically done under the guise of the defence department, which, for instance, played a central role in the development of the Internet.) The economic framework of Europe may impose severe restrictions on the ability of governments to undertake such policies.

[13] More than 30 years ago, I argued for the importance of bankruptcy law; J. Stiglitz, "Some aspects of the pure theory of corporate finance: bankruptcies and take-overs", *The Bell Journal of Economics*, Vol. 3, No. 2, Autumn 1972, pp. 458-482. For a more recent discussion, see J. Stiglitz, "Some elementary principles of bankruptcy", *Governance, Equity and Global Markets: Proceedings from the Annual Bank Conference on Development Economics in Europe*, June 1999, Conseil d'Analyse Economique (Paris), 2000, pp. 605-620; B. Greenwald and J. Stiglitz, "Information, finance and markets: the architecture of allocative mechanisms", *Industrial and Corporate Change*, Vol. 1, No. 1, 1992, pp. 37-63.

[14] At the time of the adoption of the United States Constitution this may not have been that much of a concern; America was not an international power; it was, in effect, checked in any international ventures by the powers of the time, e.g. Britain and France.