

Crisis, Contagion and Bailouts: What's Next for the European Union?

In the run-up to this week's announcement of the European Union's \$960 billion stabilization plan, Wharton management professors Mauro Guillén and Saikat Chaudhuri, and Jean Salmona, founder and chairman of the editorial board of ParisTech Review, participated in an interview with Knowledge@Wharton on the likely outcomes from the financial crisis facing Greece, some of its sister countries and the European Monetary Union more generally. How did events spin so out of control? How will the politics of the crisis affect the Eurozone's economic performance? And will there be similar crises in the future? Guillén, Chaudhuri and Salmona addressed these and other questions -- as well as many longer-term issues relevant in the wake of bailout efforts -- on May 7, just before the huge financial support package was announced.

A full transcript of the conversation appears below:

Knowledge@Wharton: ...Thanks to our panel for joining us. I would like to start off by asking professor Mauro Guillén if he could put into context how Europe got to where it is today, particularly in the case of Greece, and just set the stage for our conversation coming up.

Mauro Guillén: Thank you for inviting me. What I would like to say is that obviously the situation is not one which anybody would like to be in. I guess the Greeks have to play the role of being perhaps the weakest country right now in the European block and, more specifically, in the Eurozone. They are in the center of the storm. They are by no way I think the only country that is facing certain very important challenges having to do with the public deficits and with a lack of competitiveness and so on and so forth.

But I guess the background to all of this is, of course, a little bit more than 10 years ago that some European countries adopted the euro as their currency. But they didn't think about situations in which maybe the adoption of a common currency would come under stress and, in particular, the fact that even though there is a common currency in the center of Europe – European central bank – there are no mechanisms in place really to make sure that all the countries are playing by the same rules and that all the countries are essentially complying with some basic criteria, which are half economic and half political. So this is not just about economics. It is also about politics – criteria having to do with budget deficits and having to do with the way in which you are making sure your country can remain competitive after you have essentially given away a very important policy option in your tool kit, which is to devalue your currency. So you are, in other words,

surrendering your sovereignty in terms of your currency, which means that when you are in hard times then you cannot devalue in order to become more competitive.

But at the same time the architects of this monetary union ten years ago didn't think about what should be done in case one or more countries actually get into trouble. They didn't think about what kinds of an institutional arrangement and decision-making procedure should be in place to tackle in real time a crisis that unfortunately, you see – as always happens with these sovereign debt crises they build up over a very, very long period of time. But [the crises] unfold very quickly. So the roots of the situation are to be found in the last five years or 10 years and probably the last 15 years, since Greece, Portugal, Spain and so on became members of the European Union, right, in the mid 1980s. But the unfolding of the crisis actually has taken place over just a period of two months or three months and, therefore, if you didn't plan, especially institutionally, for the situation then there is no way in real time that you can actually put in place the mechanisms to cope with the situation.

Knowledge@Wharton: There was a recent column in *The Financial Times* by Martin Wolf, which stated that Greece is being asked to do what Latin America did in the 1980s. That led to a lost decade with the beneficiaries being foreign creditors. Mauro, could you comment on that also because I know you follow Latin America very closely.

Guillén: Well, the Latin American crisis was similar in the sense that these countries just at some point could no longer service their debt. But there were two major differences. So I disagree with Martin Wolf. I don't think the analogy is that great. The first difference, of course, is that each of these Latin American countries had their own currency. They continue to have their own currency today. Some of them were pegging it against the dollar but that doesn't really matter. They had their own currency. They could actually use a devaluation in order to try to get out of the problem.

The second big difference is that the reason why they got into trouble was that because they borrowed immense amounts of money, which they did not invest well. They used essentially the natural resources of collateral. The other big difference, of course, is that in the Latin American crisis, the banks that got burnt as a result of it were the U.S. banks – the American banks. Whereas in the case of Greece, the lenders have been primarily other European countries. It involves some banks. It also involves individual savers and so on and so forth. So I would say that the situation is actually very different even though the type of phenomena appears to be the same.

Knowledge@Wharton: So we have seen – in the last two years we have gone from what was called the Great Moderation -- where business cycles were supposed

to be smoothed out and everything in the world economy was going to be hunky dory because we had solved all the economic problems -- to this week where we have demonstrators burning banks in Greece. So that's a pretty quick progression. Further, to look at how we got from there to here, professor Chaudhuri, could you explain a little bit from your point of view having grown up and been educated in Germany, what is the German perspective on the crisis? And what has been the progression of the crisis and how has it changed in, let's say, the last two weeks or so?

Saikat Chaudhuri: Very, very interesting point. Steve, thanks for mentioning my background. Some of you might be confused. I am Indian, but, yes, I grew up in Germany so I am quite comfortable in making these statements. When you hear me speak German then you will be really puzzled. It was not as common but it was indeed great growing up there and I feel I have the perspective.

I think we have to look at this at the EU level and then also at the German level. Perhaps a critical piece of it was this hesitation or this reluctance on the part of Germany – and [German Chancellor] Merkel in particular – to quickly come up with part of a solution. I think if we look at it per the framing of Mauro essentially what, I think, this crisis exposes is that the EU [European Union] is still very much a federation, which coordinates but is not integrated and, hence, the difficulty in managing crises or even in monitoring and implementing various measures. This also became clear on a very different and compared to this perhaps a minor crisis, which was the air space closure as a result of the volcanic ash clouds. Because while euro control exists to coordinate between the different entities it is not one integrated European sky. It led to some delays in decision-making and, as a result of which, we had that prolong as well. So I think it is good to see this as a coordination challenge.

From the German point of view, they are both economic and political compulsions, which I think have led to the hesitation of Merkel and others to cede to this request by Greece for an emergency package and, in particular, move swiftly. On the one hand, we have Germany coming out of the economic crisis – the previous one, the big global recession. And, yet, the economy is not quite strong yet. At the same time, Germans have a history of being conservative spenders, fairly good with their economy, have worked very hard and given, especially this time of coming out of another global recession there is understandably a certain hesitation also in the public to going forth and agreeing to such a bailout package for a country that is viewed in Germany as having been reckless. If we take more radical views perhaps shouldn't have been given as quick membership without sufficient oversight such as Greece. That's of course an extreme view, but that's, I think, some of the sentiment.

Compounding this is, of course, the political situation right now in Germany because you probably know that this weekend the CDU and FDP, which is the

coalition and power, is facing an important litmus test politically because elections are on in North Rhine Westphalia, which is the most populous state in Germany and also the largest economy. By all indications it seems difficult for that coalition to win that state election.

Now it is not just about state matters. But in the German system if they lose those elections then the upper house in German Parliament also would be a minority position for the CDU and FDP, which would make Merkel's life extremely difficult in governing going henceforth despite the fact that she is firmly Chancellor and in power at the federal level. So that really compounds the problems. So I think Merkel was not trying to not respond to the crisis, but she would have preferred for this to be delayed – a decision to be delayed until after the elections are over. That really played a role as well. So we have to view her reaction, of course, things hit such a bottom that there was no choice. And, as a result, Germany had to act. And I think the view is changing now that, look, the German situation is one thing, but if the EU goes under then there is a lot more that's at stake.

Knowledge@Wharton: Thank you. You both raised interesting points. One key point is about the central role of currency in this crisis and how it renders Greece unable to kind of rescue itself because, typically in these cases a country would simply devalue its currency, increase its exports, have a rough time for a while, but eventually grow its way out of the problems that it has. And that option is not available to it. Then we hear about the political challenges in Germany. Can you have monetary union without having political union, which is the case right now in Europe?

Chaudhuri: You can, but the challenges are extensive, I think, -- ones of oversight. I don't know if political union is going to become a reality because of so many different cultures and sovereign nations who are proud of their heritage and their history. So I think that's almost very difficult to achieve. I think though what this has exposed, just like with the global financial crisis, is that the oversight mechanisms perhaps need to be overhauled. I think that's the direction perhaps that this will all take. In addition to coordinating some things and I go back to the European ash cloud situation, they will integrate European skies. It is not quite a political union, but at least at an institutional level you may get some flavor of that in particular demarcated areas.

Knowledge@Wharton: Mauro?

Guillén: Well, I think that's a question for somebody who can represent France. Because as you all know the British were always very reluctant about any type of monetary union and, of course, they opted out. The Germans were very reluctant because they felt they had a great currency and they had a great institution even though, by the way, historically there is some debate as to whether actually the Bundesbank has been as good at keeping inflation down always in the post World

War II period. There are some economists who have written about this and there's a myth and there is a reality about the Bundesbank, right?

But like with many other European projects, I think, the monetary union was something that came from – the biggest impetus came from France actually. I would tend to think that it was a very good idea in many, many different ways and it certainly helped the European periphery like we talked about, but I think everybody is thinking about not just Greece, but also three or four other countries that for now have not been named. But the issue here is, I think right now, is obviously it is two-fold. One is what can we do now? It is unfortunate that the political cycle in Germany is not collaborating with the need to take action swiftly. And then the second issue is can something like this really work without some other kinds of mechanisms.

I don't think you need a political union, meaning a European president for example or European-wide election for the executive branch of government – that kind of thing – in order to manage something like this like a currency union. But what you need is, which is entirely lacking, you need a mechanism for dealing with, for example, something like the Greek case. And, again, the Greek case is very extreme for a number of reasons, beginning with the fact that they were concealing the true extent of the problem. But you need some mechanism and that's why there has been all of this hesitation coupled with then 'nothing can really happen without the Germans being on board.' And then there is the other sideshow of the idea of bringing in the IMF, which of course it just so happens that there is a Frenchman there at the helm of the IMF, which is probably a good thing right now. There was a Spaniard up until three or four years ago. But the point that I am trying to get across here is that I think it has become readily apparent that something is missing in the institutional set up to make this work. It is not necessarily – you are not going to have to go, I don't think – as far as having political union. And, by the way, there were people 10 years ago or 12 years ago who were exactly pointing out this problem that what if a country actually gets into trouble – a country that is, say, a member of the common currency?

I am actually very much looking forward to listening to the French perspective because I think that everybody is talking about Germany, but actually I'm saying something nice about France. I think a lot of the things that are happening in Europe happen because the French come up with the intellectual reason for implementing them. And I think the currency union was a very good idea in many ways, but it was an idea that the French championed back then.

Knowledge@Wharton: So we look forward to hearing your comments on this Jean. And also, Jean is the one member of the panel who is an entrepreneur as opposed to an academic, so it is a nice mix that way. So we have most of Europe represented and all walks of life.

Jean Salmona: I don't know whether I will have to apologize for being an entrepreneur. Besides, I am working in private equity, and I am not sure that qualifies me really as an entrepreneur. Now, before I answer regarding the French situation, let me give you a few ideas of what the background is.

We consider that not only in France, but in most of Europe, we have been living much higher than we should. We are living higher than what our situation would make it possible for us due to two elements.

The first one is the increasing debt, private debt and government debt, which results in overestimated household incomes ; and, the second is the fact that we have – especially in France, but in most of Europe too – very generous social laws: we have excellent Social Security systems, we have excellent unemployment risk coverage, we have a very high level of redistribution of income. All that makes it possible for the basic man in the street to say, no problem, if anything happens to me the state will take care of me. And, therefore, the general mind is not – you remember the world of John Fitzgerald Kennedy – don't think of what your country can do for you, think of what you can do for your country. In Europe, and especially in France, it is exactly the reverse. "What is the state going to do for me? After that I shall see whether I can do anything for myself and, then only, maybe, for my country." This is the first point. The second point is that people in Europe by and large do not trust their governments, which seems contradictory with the first point. They think that their governments are mainly focusing on the short term and re-election, not on structures and the long term, and that they are not reliable. The present European crisis is precisely the result of that inability to look at the long term: governments are trying desperately to find out how to extinguish the fire, whereas they should have identified a long time ago – maybe 20 to 30 years – the risk of a fire and worked on how to prevent it from starting. Therefore, people act in such a way that they count on the state to help them in the day to day life, but on the other hand they do not expect their government to be able to solve the major problems.

Besides, a major constraint in many European countries is the unions. We have very aggressive unions i, most of which are ideology driven. Just after World War II, the communist parties all around Western Europe were very strong –. They were very strong – In Italy, in France more than 30% of the electorate would vote for the communists. Therefore, the unions were very much communist and socialist dominated. The unions are still dominated by an old anti-capitalist ideology. They don't like the enterprises neither the entrepreneurs, even when they are employed by the state.. You probably know that in France we have a strike every second week The last strike of the French railways was so strange. because the workers did not even know why they were on strike. Really. "Why are you on strike?" "I don't know. Probably against government. Probably against [the company] – but we're on strike, definitely." This aggressive and irrational behavior makes the situation and negotiations very complicated. How, with such unions and lack of trust in their

governments,, can people accept any decrease in their salaries and living standards, which will be made necessary by the crisis ?

Now as concerns the Socialist opposition, at least in France, let me give you a sentence by former Socialist Prime Minister of France Laurent Fabius, one of the fathers of the Euro idea, when he was member of the Government : "We have to be realistic. That means that we should take into account the present situation. Not of course the present situation as it is, but as it should be." And the fact that some leaders look at the situation not as it is, but as it should be, explains a lot of our problems in Europe.

This lack of trust in the governments, the opposition, the unions, ends up in a search for scapegoats to blame. Of course, first the banks – which is not necessarily stupid. Then immigrant workers. , I don't know whether you have looked at the recent elections in Hungary. The far right party, which is very much against immigrant workers and gypsies, made a lot [of political gains]. It is not only in Hungary. Remember what happened in Austria, what the present situation is in Italy, in France where the recent [local] elections [resulted in French politician Jean-Marie] Le Pen and his far right party "Front National" getting more than 15%. It works to blame scapegoats !

And now, coming to the euro. I don't see how we can go ahead without not only coordination between government policies, but much more than coordination – a common European economic policy. Having a common currency without a common fiscal system without a common social system doesn't make sense. At present the mind of the French people is let's do something, but at the end the Germans will pay. And [French President Nicolas] Sarkozy has been quite good in convincing German Chancellor] Merkel [to pay] in spite of her political situation today. Coming back to your question, business in France is not that bad. In my field, for instance, , which is private equity, we are facing one main problem : the banks are reluctant to take risks, especially to participate in LBOs. However, if we find some good company to acquire, , which is the case in some domains like suppliers for nuclear energy for instance, there is no problem with the banks

Some sectors develop only due to state subsidies. For instance, the renewable energy sector is developing well, , but only because it is heavily subsidized by the state – in Spain, in France, everywhere in Europe. Thanks to these subsidies, the power operators buy power from renewable energy operators at a much higher price than they sell to the public. If there was no subsidy, wind farms and solar farms would not be feasible.

You can invest in solar energy or wind energy as the contracts signed with the power operator guarantees that it is going to buy power from you at subsidized price for the next 20 years. But 15 or 18 years from now who knows what is going to happen. And in between the conditions are changing every year and the subsidies get a little bit lower for the new contracts, not the former ones.

So to sum it up, the people in the streets are disoriented. They don't know exactly what to do or where to go. They think that the state will protect them. They hate the banks. They hate the rich generally speaking, without knowing exactly what the "rich" are. You should remember that the leader of the French Socialist party Francois Hollande said once, a couple of years ago, "I don't like the rich"., forgetting that he is himself a "rich" due to the real estate property he owns. This shows that it is not a rational but an emotional attitude.

And business is not too bad. But if nothing happens concerning a common fiscal system and a common social policy, then I don't know where we are going. To be frank, I am quite pessimistic.

Knowledge@Wharton: Thank you. We have quite a few more questions and time, but I want to encourage anyone who has a question to step up at any time to the microphone here, and we would like to take them as we go because we will get too far on and move on to other subjects. I don't want to neglect this one.

Knowledge@Wharton: This is Janet Kersnar, our editor in London, who oversees many of our international editions and helps with editing.

Janet Kersnar: Good observations. Many thanks for them. I have heard in various circles people say that it is not Greece, it is not Spain, it is not Portugal, it is not Ireland that we should be most worried about. It is the U.K. What are your views on what's been happening there, especially given the election results? Anyone.

Kersnar: Saikat?

Chaudhuri: I think the U.K. faces two challenges. One is the immediate political situation as well the coalition government and what can happen. The second is an economic one undoubtedly because if you look at it the U.K. is very dependent on the service sector – financial services and so forth. And they are the ones who are still struggling and coming out of the crisis. Germany and France by comparison have been able to do so because at least the Asian and Latin American markets have started growing and so export has somewhere to go. So I think that the challenge lies in the somewhat restructuring of the economy and finding new drivers. That is very much there. But, at the same time, I don't think the U.K. is at risk of immediate fiscal collapse. So there is some stability there but I do think there will be some restructuring necessary.

Guillén: The U.K. has one advantage by definition, which is that they have their own currency. They can adjust that way. But they are running the largest deficit right now. I was just checking the numbers of all major economies in the world. It is definitely higher than Italy, Spain, and Portugal. It is also higher than Greece's as a percentage of GDP. The U.K. doesn't have as much debt accumulated, right? But the problem is that they placed a big bet on financial services. Their manufacturing essentially went south. Not even the Germans could turn around some of their

companies. The Germans invested in the British automobile industry and they couldn't turn it around.

Chaudhuri: Now the Indians are trying.

Guillén: And now the Indians are trying. So they are at a crossroads. I think it is obvious. But they do have more options at their disposal than other countries. And, of course, they do have a very, very strong reputation for living up to their obligations unlike other countries unfortunately. So they do have goodwill. And they do have other options. And, of course, the outcome of the election doesn't help, right? Because now I guess in the next few weeks there is going to be a lot of discussion as to exactly who forms a government. So it is not clear to me that the U.K. is in great shape. They are facing a lot of challenges as well.

Knowledge@Wharton: I want to return to one of those countries that doesn't have a lot of options, which is Greece, and look at some of the numbers between the money that they are getting from the EU and the IMF [Editor's note: this podcast was recorded on Friday, May 7, before the later announcement of a far larger rescue package on Sunday, May 9]. It is a \$146 billion rescue package, which is up quite a bit from just a couple weeks ago. That represents about 145% of their GDP projected out into 2011. So that is a pretty big chunk. I think another way to look at it is that if Greece repudiated its debt today, if they didn't pay any principle or any interest in order to just take care of their internal debt and other obligations, they would have to run a GDP surplus equal to about 8% of their GDP. I don't think anyone thinks that is likely to happen any time soon. So that gives you some idea of the kind of trouble that they are in.

So under those conditions, is it likely that this rescue package can actually work? Is it not likely that Greece is going to have to at some point, whether it is 6 months or 12 months pull out of the monetary union so that they can devalue? There may be other options, for example, all of Europe could devalue the euro. That would help Greece, but it has tremendous implications worldwide. As unthinkable as it was not just a few weeks ago for a country to pull out of the EU, given what's happened just yesterday, Spain, Portugal's credit default swaps, if that's not a dirty word anymore, for Spanish and Portuguese banks rose to record levels yesterday. We all know that the speculators in the markets are betting against them. So what are the odds of Greece pulling out of the monetary union even if it were only temporarily? Mauro, please.

Guillén: Well, if there is a bailout, what that essentially means is that then Greece buys time. They don't have to go to the credit markets to place their bonds for a while – roughly speaking maybe for a couple of years. The problem is that they have – you see the way these government bonds work is that they put three months in maturity or six months or whatever. So countries need to repeatedly go to the markets to keep on running on their debt. Greece has a problem, of course,

in that this is not a new thing. This is not something where there wasn't a problem three months ago and suddenly we have a problem. The problem has been building up for a number of years. And the problem has been masked in a way by funds that were coming from Europe and has been covered by the appearance that everything was okay. They are part of the euro and so on and so forth. But they have been living beyond their means. They have lost competitiveness. They have a huge trade deficit – really big. I would challenge anybody here in the room or in the wider Knowledge@Wharton audience to name one or two or perhaps even three – if you can – Greek companies that are making a dent in global competition. By the same token, it is very hard for foreign companies to invest in Greece and be competitive globally from a Greek base. Wages are out of whack.

Through devaluation or by getting out of the euro, which will be the same thing right, all you accomplish is you just automatically reduce the standard of living of everybody in the country. People need to adjust -- reverse imports. They become more competitive. You take it from there. But absent that there is no other way of adjusting – unless somebody wants to foot the bill or keep on subsidizing them – but through a sharp reduction in standard of living. By the way, that is going to happen in a lot of countries that are living beyond their means. That includes the United States. That includes the United Kingdom. It is not just Greece. The problem is that Greece doesn't have many options because it has driven itself into a corner.

They don't really have any part of the economy that is that competitive. They don't have companies that are dynamic. They are in a very, very difficult situation. So it is a number of things that have been building up over the last 10 to 15 years that they have failed to address. Not only that they were covering up the evidence. Moreover they were, I think this is another problem that Greece has, which is that some of their best people actually have left the country. They live in London or they live in other places. So they don't even have the best-prepared people in the country. Many of them have left over the last five or 10 years.

Knowledge@Wharton: So let me just extend that question a little bit and make it even a little tougher for you folks, which is what are the odds that they will either devalue or restructure their debt, which is in effect a partial default? Or a negotiated default? Or both? Could you give your sense of that?

Chaudhuri: It is hard to place odds on some of these things. But I think that what Mauro pointed out very rightly is that harsh measures will have to be taken. Part of it probably will have some form of that. We saw that in the financial crisis here. The situation with how the banks were saved, for instance, had elements of perhaps subsidy in the short-term involved. Maybe that's there. I think the largest question is – and this is going off of your point, Mauro, that the EU will have to decide on what it wants to do for a couple of important reasons beyond the immediate fiscal condition, which is that, one, what type of precedent do they want to set? Because is this acceptable? Are subsidies and so forth acceptable going forward? If that is

the avenue that they choose or a harsher step like step out of the union or something along those lines.

The second part is psychological in nature because we have seen that, in particular in stock markets, they are very integrated. They are reacting very sensitively. Nobody wants to see a second global crisis even as we barely are starting to emerge out of the first one. So I think a lot of these compulsions will also dictate what type of action is taken at least in the short term.

Knowledge@Wharton: We have a question before we get to our next speaker. Could we have your question please?

Rahilla Zafar: [A Knowledge@Wharton correspondent] My question is for Mauro. In terms of the bailout money that Greece is getting, is any of that going to go to improve its institutions so they are less bureaucratic and they are more transparent? Because what's the point of them getting all this money if that's not going to change?

Guillén: That's under discussion. As you know this is a very controversial issue. That used to be the way in which the IMF tended to operate, especially in the beginning of the 1980s. That is to say when a country knocked on the door saying, "We can't keep going. We need a bailout. Would you help us?" The IMF typically responded – since the 1950s, but this became more of a norm in the 1980s and into the 1990s – typically responded [by] saying, "Sure. We will help you, but by the way you need to change this and that" and so on and so forth.

The IMF came under attack for actually going too far in terms of asking countries to do certain things that actually in some instances proved to be counter productive. So it is tricky. The other thing there is a professor here at Wharton, Witold Henisz, in my department who has demonstrated that when you impose reforms from the outside, when a country is in dire straits, it is actually so much more likely that there will be a backlash against those reforms. You see, it's not just about economics. We can try to figure out what is the best technique of solution. We have great economists here at Wharton who could tell us what is the best solution from a technical point of view. But Saikat just mentioned that you also need to take into consideration what is possible – politically possible. And then what are going to be the consequences of this looking down the road, depending on how you proceed now. So that's why at the beginning I was saying you also have to take into consideration the political cost or the political benefits – both – of doing things in a particular way.

So Greece, first of all, what it needs is to tell the truth. It hasn't. Greece needs to avoid the situation in which they don't even know how much money there is in the country because their fiscal system – it's just a problem that there is so much tax evasion in the country. They just let that problem grow in an uncontrolled way.

That is also true of Italy, of course. With the additional problem that they have a Prime Minister that I don't think anybody in this room would like to have as a Prime Minister. I mean they have all sorts of other problems, right?

So I don't want to single out Greece as being institutionally a disaster. But it seems to be that there are a lot of things in Greece that are not working properly. So, therefore, there should be some way, right? But if you try to impose it [a solution] from outside it may not be – that's unlikely to be the best way of doing it. The problem, of course, is now we have a problem on our hands. What do we do?

First of all, I think you need to reassure the markets. I don't know what it would take to reassure the markets now, but definitely what you want to do is you to prevent this problem from spreading. And depending on the kind of response, the markets or investors or whoever may be encouraged to then think, "Oh, look at what happens with Greece. They are hesitating. Maybe we should try to make a killing by betting against this other thing over there." You see what I'm saying? So it is, I think, very important to restore confidence in the European Union, the Eurozone members, maybe led by Germany or Germany and France. They can handle the situation. The sooner that happens the better.

And, by the way, that would also be good for the United States. I want to make a remark. I have a U.S. nationality as well as a Spanish nationality and I love this country. But there is a problem here, which is that it seems as if people would like the euro fail. Right now what America and American companies need is the ability to export. It was great for U.S. companies that the euro was so strong. I don't understand why there are so many people who believe that right now a weak euro would be great for U.S. companies because one of the big problems that the United States is the lack of export competitiveness and a big trade deficit. So now this turmoil in Europe where a lot of American firms operate is actually going to be hurting the recovery here. So I think it would be good for everybody to actually try to see how we can address the Greek situation and prevent the whole thing from getting out of control. Of course time is of the essence. This is really important.

Knowledge@Wharton: I would like to come back to those ideas of the problem spreading, contagion, and also how it affects the U.S. and other parts of the world like China and India. But first I wanted, Jean, to give you a chance to talk about what you think the odds are of Greece either devaluing or rescheduling debt or partial default. There are a lot of euphemisms, but it is basically a default.

Salmona: Let me just show you a piece of paper that was printed from the Web from a very respectable think tank in France, called – "Why We Should Not Help Greece." The basic idea of that paper is that if we do with Greece with the U.S. did with Lehman, we just let them go through default, restructuring the debt, leave the Euro zone, of course, and then this creates a situation which makes it easier to solve the problems of other countries. That means betting on the idea that we can

improve the situation after Greece has left. In my opinion, the market would consider that as a weak signal and therefore let the other countries see their ratings deteriorated and the euro go down. The idea not to help Greece is quite common in many European countries: why should we pay for a country which has cheated on its accounts when it joined the Euro zone ? . As I am concerned, but it is just a personal point of view, I feel that we are not going to let Greece down.

We are going to help Greece but mainly for political reasons.. First, European banks which have bought Greek treasury bonds, including German and French banks, would have a big problem if Greece would restructure its debt. Second, Sarkozy, as you probably know, is probably going to run for re-election two years from now. His main potential serious challenger is the head of the IMF, Dominique Strauss-Kahn. If they let the IMF take care of the Greek story, not only that will be an evidence that Europe is not able to solve its own problems by itself, but it will put the IMF and consequently Strauss-Kahn in the limelight and Mr Sarkozy cannot accept that. Already the fact that IMF took some part in the first negotiation concerning Greece was really a serious problem and, therefore, I think that really we are going to help Greece, and the other countries which may face a similar problem

Let me just take advantage of this to mention one point, which is not frequently pinpointed. We have some countries in the European Union with low salaries, such as Romania, Bulgaria, Slovakia. Remember that for instance, Renault Nissan, the French car manufacturer, is now selling very well one car, which is called Logan, a low-cost car built in Romania by the former Dacia. This helps Europe benefit from low salaries inside the Union without outsourcing to emerging countries. Of course, it creates unemployment in countries with high salary levels, but as I said, for one, two or three years the social laws can take care of that.

Knowledge@Wharton: Thank you. If we were having this discussion two months ago and I asked you what you thought the chances are of the European Monetary Union or even the EU dissolving there would be chuckles and laughs and really wouldn't be taken seriously. The question is at least a serious one now, however, low the odds might be and maybe they aren't so low. But back to this idea of asking you what you think the chances are just because it frames it in a way that forces us to think of what the possibilities are. So could I ask each of you to say as the possibilities for contagion for speculation spread to weaker economies, which would include Portugal, Spain, Italy, Ireland and you are throwing in France so who am I to challenge that? So what are the odds that this whole thing could unravel? Could we have a European meltdown? These are the kind of headlines that are in *The Financial Times* these days. Mauro, I'm putting you on the spot.

Guillén: Contagion has already started. The indicator is the one that you mentioned earlier.

Knowledge@Wharton: Credit default swaps.

Guillén: CDSs or you use the premium that these countries are having to pay now to place their debt. It is quite clearly the case that Portugal, Ireland, Spain and to a lesser extent Italy – even though I think Italy is much more vulnerable than any of the others quite frankly – but they are already experiencing the effects of this, right? So it has already started. The question is how far is it going to go? But your original question was what is the likelihood? It is a very difficult question to answer. I would tend to think that it is not that likely that the euro would unravel. I don't think it is very likely. And it's not very likely because all it would take for the whole thing to be saved is for the Germans to send a very clear signal that they are not going to let that happen.

And if things get – in the next two or three months – bad enough that there is a danger that it could happen [the disintegration of the Eurozone] I think Merkel would essentially stand up and say, "Enough is enough. We are going to be supporting this and making sure that we get out of the problematic situation that we find ourselves in." Probably that would need to be done in conjunction, obviously, with France.

Knowledge@Wharton: To interject one thing, isn't it a problem that the longer you wait the more expensive it gets -- if Germany had stepped up six weeks ago or even two weeks ago it would be costing Germany a lot less than right now?

Guillén: There was a political reason for Merkel to wait. It is this weekend, right, when I guess that problem will be behind us – at least for a few months. I forgot now when is the next regional election in Germany. It is probably in the fall? [The state holding the election] is such a big federal state in Germany that it makes a big difference in the outcome. Let me rephrase the question. How likely is it that Germany will say at some point, "Enough is enough. It is in our best interest to actually bail the whole thing out if that's what it takes" – in conjunction with France, of course, which is the other large economy. I think it is very likely that they will do that if they feel that the whole set up becomes threatened. Because you see the Germans have been "paying" for a lot of this.

But it is also a fact that German companies and the German economy have benefited immensely from the creation of a European single market for goods and in many respects for services and also from the monetary union. And the reason for that is pretty obvious, which is that Germany, together with The Netherlands and a couple of other smaller economies, are among the world's most important exporters. The German economy could not survive without exports. Most of German exports, even though China and the U.S. are important markets for them, go to France, go to Spain, go to Italy. So for them this is incredibly important. Germany cannot afford for the European common market to implode.

So if things get really worse and they realize that they are getting worse and I am hoping that they would realize that they get worse – if they get worse – or really

bad – then I think they will take decisive action. They are going to orchestrate some kind of an agreement, taking the lead. Having said all of that, again, I think it is in the best interests of the United States, it is in the best interest of pretty much everybody right now around the world that this problem in Europe gets resolved as quickly as possible. So I don't think anybody should take pleasure in seeing the European Monetary Union or the European Union [experiencing difficulty] – and quite frankly I am dismayed at the fact that some commentators, especially in the press, are coming very close to celebrating like saying, "We told you that this was going to happen to you." As if this wouldn't have any consequences on the economic recovery here in the United States or for that matter recovery around the world. It would have devastating consequences.

Knowledge@Wharton: But it is proof that we need Knowledge@Wharton High School because the economics education in this country is obviously missing something. So, Saikat?

Chaudhuri: I strongly agree with Mauro on this because I really think that it is very unlikely that they will unravel the euro or other aspects of the EU. The basic situation is now that *de facto* we live in a globally interdependent economic system. It is not just about Europe. It is about the global financial markets being linked. It is about exports happening. It is about markets opening up. If you look at Proctor & Gamble's [earnings] results declared very recently, or IBM's, clearly their recovery is coming from other places than their domestic market right now. That's why they are posting returns. So whether we like it or not – and the stock markets are certainly sending us those signals. That's the *de facto* situation.

So the question becomes – this goes back to your point Jean – how can we best align and perhaps address discrepancies? It is there at the social level. Greece was enjoying retirement at 50, for example, which was a vast contradiction to many other countries, which were going elsewhere. It is at the economic level. It is at the political level. And really it is the institutions, like we see in the financial system, which have to get together and develop these mechanisms. I think there's no choice.

The other point I want to make is that there is a short-term consideration, a mid-term consideration, and a long-term consideration, which has been implicit, right? Yes, Merkel [s party suffered a major defeat in regional elections last weekend] which will make it hard for her to govern from Berlin and Germany as a whole. But there are much larger implications here for the system. So if it comes down to it, that notwithstanding, her focus will be on saving the German economy by saving the EU.

I think the point here is how can we achieve that integration in a meaningful way? You were drawing an interesting distinction within the EU, right? Because it would be easy if all the new entrants – or not even new entrants – if the weaker

economies in Europe, including the Eastern European ones were also faltering at this stage to make the argument that the whole EU and the euro is a failed experiment. But it's not the case, like you said. The Czech Republic, Slovakia, Romania and so forth are much better integrated. They are the lower "cost" production centers, outsourcing centers, with high expertise mind you within the EU. And it works. Greece was not integrated for the various competitive reasons or lack thereof that we were talking about.

Salmona: I would just like to make a point. We have been talking a lot of Europe. But we haven't talked about the United States. There is a feeling in Europe – I would like to know what my colleagues here think – that China is not going to buy U.S. Treasury bonds for years and years and years. Due to the fact that European economies are in big trouble and will have to reimburse their own debt for a long time, who is going to buy these Treasury bonds? And what is the future of the dollar? Because the future of the euro may be a bit different if the dollar has problems.

Knowledge@Wharton: Who is going to buy if the Chinese don't buy?

Guillén: I don't know why everybody looks at me.

Knowledge@Wharton: I think it's because you are the Head of the Lauder Institute. So what happens if China decided?

Guillén: My sense is that we are formulating too many "ifs" and this is becoming really complicated, at least for me, to handle. What if the Chinese had a big problem? I was reading the day before yesterday an article in Foreign Affairs about China about its foreign policy and about its neighbors. I wouldn't like to be the foreign minister for China. It is so complicated. It borders with I don't know how many countries. Its single border is a problem or a potential problem. So China will surely have a lot of problems in the next few years – starting with demography [?] – the banking system. What are they going to do? Are they going to be able to make a position from being a low cost manufacturer to being a higher value added producer? What about the domestic market? How about qualities between the coastal areas and the interior? The political system – it cannot stay like that forever. There are all sorts of problems. So I fully agree that we cannot expect China to continue playing the role that it has been playing because it is going to have to pay more attention to other things that are more about their own economy and political system and how it relates to the neighbors.

So what is that going to mean for the dollar? Well, I think Americans, all of us in other words, are going to have to think very hard about what we are doing. And our standard of living is going to come down on average. I think this is inevitable unless we become more competitive. It is a bad thing that now when there is uncertainty in the world actually the dollar suddenly becomes more valuable because that is hurting some of the insipient export activities and out of this economy. So it is

actually, I think, bad that this is happening. But people seem to celebrate it. But suddenly the dollar is a little bit stronger. It is actually the last thing that we would like to have right now in the U.S. – a strong dollar. What we need is a relatively weak dollar. Without making any fusses about it. But we need to reduce the trade deficit and we need to become more competitive and import less. This is actually producing the wrong set of incentives. But, again, I think there are too many “ifs” and too many moving parts in the questions that were just formulated. Again, I think, right now given that the hotspot seems to be Europe – that’s the center of attention now – what we need to do is to try to resolve the situation there and then take it from there. But if Europe implodes or just contagion continues then I don’t think that’s good for anybody. So we need to stop that as quickly as possible. So hopefully Merkel will emerge from the weekend stronger, hopefully, and she will have more of a freehand in terms of orchestrating it through a response to the situation.

Knowledge@Wharton: We only have a couple minutes left and I was going to ask each of you to take a minute or two to sum up, but Mauro I think you just did. Saikat would you give your wrap up of this please?

Chaudhuri: We will see more crises. That’s just the nature of it. I think it is a good time to start thinking about the right institutions and mechanisms at those levels, which can respond to these types of crises in an effective fashion. And that’s been the lesson from the goal of financial crisis. I think that’s the lesson from the Greece package. I think that knowledge reached a certain level in Europe [and] that we will see a strong response coming from Europe, from Germany, France and other countries. They can’t let it [the EU] fail. It’s that “too big to fail” type of concept applied in a slightly different way. So I am fairly confident and optimistic that things will be turned around and we will see that happening very shortly.

Salmona: During the Second World War, Winston Churchill could get the British people to accept very strong measures because it was for the war. You remember his famous speech about “blood, sweat and tears”. The problem in Europe is that people do not feel it is the war although actually it is the war – a different type of war. Again, sorry to quote again my French co-citizens, but one of the heads of the socialist party said last week, when they had to vote in the Parliament “for” or “against” giving a very first installment of €6 billion to Greece, he said, “Eventually, , we are going to vote “for,” but I must insist on the fact that we are very much against the hard measures which Greece is taking now.” Which means that in France, if they come into power after this government, they are not going to promote similar measures. So this is really serious. And I think that only a set of measures which would reorganize at the worldwide level the financial system, not only is technically necessary, but would have a psychological impact on the people in Europe and on the voters. Unless something like that happens -- and the U.S. has to take the lead we are running towards a disaster in Europe, and therefore in the whole world. I definitely hope that [President Barack] Obama, Nicolas Sarkozy,

Angela Merkel and the European Commission , together with the IMF [International Monetary Fund] say, “Enough is enough. Let’s take some very strong [measures].”

Knowledge@Wharton: Okay. I just have to ask then. What would that look like? What would those measures that you are talking about – what would they be? What would that look like?

Salmona: A first measure is to regulate the banking system, preventing the banks from doing what they have been doing in the past, especially play short on some government bonds – don’t blame just a few traders including my two famous fellow citizens who were working for Société Générale and Goldman Sachs. First regulate the banking system not by limiting the size of the banks but by preventing the banks to use their deposits to gamble through hedge funds, to do it.

Knowledge@Wharton: So maybe a higher reserve requirement, for example.

Salmona: Yes. And separating commercial banks and investment banks, making it impossible for a commercial bank to bet on derivatives, for instance.

Knowledge@Wharton: Will there be a financial meltdown in Europe?

Salmona: I don’t know. Maybe. And people are going to wake up saying, “But that’s not possible. I am not going to die now. Nobody had told me that.” So I think that only a worldwide movement, which would impact emotionally the people who vote, can do something. If not, people will refuse to wake up.

Knowledge@Wharton: Does that mean we need a second crisis to wake up?

Salmona: No, no. This one is already fine.

Knowledge@Wharton: Thank you all very much.