Event Transcript

Global Economic Prospects, Fall 2012

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Chair:
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Unedited rush transcript

Carla Hills: Good afternoon. I'll ask you to finish getting your luncheon, but we want to have the full time to this really outstanding program. I'm Carla Hills. I'm privileged to be a member of the Board of the Peterson Institute and I've been invited to chair today's meeting. Let me begin by welcoming each and every one of you to this special edition of the institute's Semi-annual Economic Outlook Panel.

You are going to hear from three of the institute's outstanding economists who have said they're going to do double duty for us. First, they will give us their outlook for the major areas of the world economy covering the up and downside risk facing us and as is usual in this series, we will move on and we will cover, because of the timing, the elections Tuesday, the Presidential and Congressional Elections, we will hear from them about the macro policy issues that the president and his team will face in this second term.

I'm absolutely delighted that my role today gives me the opportunity both to introduce the Peterson Institute's newest senior fellow and to welcome home our new CEO. We will begin with the US outlook presented by Dr. David Stockton who has just joined the institute and will be on resident as a senior fellow here starting in January.

He's also a senior adviser of Macro Economic Advisers. David, until recently, served as director of the Division of Research and Statistics at the board of governors of the Federal Reserve System. During his decade of service as the Federal Reserve Board's Chief Economist, David oversaw that preparation of the Macro Economic and Financial Market Analysis and Forecast for the board of governors and for the Federal Open Market Committee.

We are thrilled that David would join the institute and his outlook on the US economy will be a semi-annual feature of these economic outlook panels as we go forward. Secondly, we'll hear from Dr. Adam Posen who will discuss the outlook in the Euro area and its implications for the US economy and American economic diplomacy.

As most of you know, Adam will be succeeding Fred Bergsten as the Peterson's Institute president as of January 2nd. Adam is returning to the institute after service of three years as a member of the Monetary Policy Committee of the Bank of England. We earned global recognition as an influential advocate of Central Bank activism in the context of the financial crisis.

He's in his third term as a member of the Panel of Economic Advisers to the Congressional Budget Office and is co-founder and adviser to the INET Council on the Euro Zone Crisis. Today is his first public appearance since leaving the Monetary Policy Committee on August 31 and I am delighted to welcome Adam back to this hall and to look forward to his repeated appearances at this podium and on that platform in the coming years.

I will note at this point that Adam remains in a press blackout because of his Monetary Policy Committee's work with respect to the UK economy and the Bank of England until December 1. However, David who has just authored a just published report to the Bank of England forecasting capacity will be happy to respond to any of your questions on those issues just as Adam will be pleased to comment on the US outlook.

The third speaker is Dr. Nicholas Lardy. The Anthony M. Solomon Senior Fellow here at the Peterson Institute who will give us his outlook for the Chinese economy and for the economic implications of the Chinese leadership transition that is ongoing in Beijing as we speak. He will also talk about the challenges he sees both issues presenting to our US leadership.

Nick is universally regarded as the world's leading scholar on the Chinese economy. He is a prolific writer of outstanding books and articles. His most recent book published just this year; Sustaining China's Economic Growth After the Global Financial Crisis not surprisingly was a recipient of very high acclaim.

Nick joined the institute in 2003 from the Brookings Institution where he was a Senior Fellow of the Foreign Policy Studies Program. Before Brookings, he served as Director of the Henry M Jackson School of International Studies at Washington University and before that he taught at Yale.

Nick's outlook presentation on China is a regular feature of the institute's semi-annual global outlook. Each speaker will speak from this podium because we have charts that will be on the board; following their speeches. They will go to the panel up in front of the board and each speaker will speak for roughly 12 minutes to present his views.

Not enough to get all of their wisdom, but you will have a chance during the lively exchange that I anticipate following their remarks. David, Adam and Nick are prepared to address during the discussion period the full range of fiscal, monetary and currency issues confronting President Obama in his second term and the 113th Congress that will convene January 3rd 2013.

We will continue our discussion until about the clock strikes two at which time the program will end. David, will you begin?

David J. Stockton: Thank you. It's a great pleasure to be here today and to be joining the Peterson Institute. I'm really excited about having both access to the resident and visiting fellows here which is very exciting for me as well as the opportunity to interact on a regular basis with all of you. I'm really looking forward to that.

I'll leave it to you folks to determine whether or not having been the chief forecaster at the Federal Reserve is a qualification or a confession but we'll have to wait and see about that. Let me start with the outlook for the US economy. Let me start with what I think is the most distasteful part of economic forecasting and that's actually having to write down numbers.

Here's both the point forecast and some confidence [Inaudible 0:08:11.4] around my outlook for the US economy over the next two years. It's really a picture of ongoing grindingly slow improvement in the US economy. The pickup you see between 2012 and 2013 is exaggerated by the fact that this summer's drought is probably holding down growth this year by around a quarter of a percentage point boosting growth by that amount next year assuming that we get some recovery in overall output.

You're looking at another 2% year for activity in 2013 and that means the labor market that continues to sustain increase is an employment of 100,000 to 150,000 probably a small down drift in the unemployment rate. On the inflation side, I really don't see anything in the cards that suggest that we're facing any imminent inflation difficulties. If anything, I think it's likely that inflation is going to continue to run a bit below the Federal Reserve's 2% overall objective. Underlying this forecast is some improvement in underlying private demand especially in the household side but there are still some very significant headwinds that the US economy is facing.

One of the most important of those is fiscal policy. Underlying this forecast, I've assumed that we don't go over the fiscal cliff and that we reach some sort of short term resolution that prevents that but this forecast does not anticipate a resolution of all the fiscal difficulties and decisions that will put us on a clearly sustainable path moving into the future; having said that, even if we don't go over the fiscal cliff, there is still a significant amount of fiscal restraint already baked into the cake. Some of that is coming from the continued drag from reduced government consumption and investment. That's probably worth about a half a percentage point of overall fiscal drag.

I think it's quite likely no matter what we'll lose to payroll tax holiday and that the emergency unemployment benefits will expire as it's currently scheduled at the end of the year, another half a percentage point, all of these fiscal forecast at this point that'll be written in pencil, not in pen. And as a place holder, I put in $50 billion worth of income tax increases.

That would roughly match the amount that would be forthcoming if in fact the marginal tax rates on upper income individuals do expire. That may not be mechanism by which those tax increases are delivered to the reps. There could other ways in which that could be done, but all in, I think we're looking at a fiscal restraint that equal to roughly one and a half percentage point to GDP.

So while we're getting that ongoing fiscal restraint, I think we're still going to have the Fed doing as it has told us it is going to do which is to continue its open-ended program of quantitative easing, its large-scale asset purchases in an amount that will ultimately accumulate to roughly $900 billion, maybe $80 billion a month starting in January.

They said they're going to continue this open-ended program until they see clear signs of improvement in the labor market, and on my forecast, that isn't likely to happen till the end of 2013 or thereabouts. And even that maybe a bit optimistic. I fully suspect that they're going to continue to do—their extended guidance is going to be maintained going forward.

I think while we we're going to have a lot of fiscal restraint, we're going to continue to get some support for monetary policy. On the private demand side, I think we are seeing some signs of improvement I think especially in the household sector. If you look at household loan delinquency rates, they've come down very dramatically.

Debt service burdens that are currently being faced by households have returned back to levels not seen since the early 1990's. To be sure, I think those aggregates are probably obscuring some significant amount of pain that is still ongoing below the aggregates, but I think it's a situation where we're actually seeing some serious improvement.

The most, single most encouraging development to my mind for the domestic economy over the past year has been the turnaround in house prices. The turnaround in house prices I think—if I had one lever I could've pulled to improve the economic outlook, it would've been house prices.

The fact that we're now seeing that, I think is encouraging on a number of dimensions. One is obviously some shift from either flat or declining house prices. The increase house prices provide an impetus to house purchase by lowering the user cost of capital in housing. I think the idea that the housing might actually begin to, again, look like a potentially good buy, is a good story.

Two, it's adding directly to wealth in the household balance sheets and I think that is likely to be supporting consumer spending more broadly. Three, I think all, at least some fraction of home mortgages that have been underwater are likely to not be underwater going forward if we get some continuation of house price increases and that will provide the opportunity for some households that have been unable to refinance their mortgages to do so.

I think that is yet another increase and then finally, I think in general, improvements in the overall performance of home mortgages is likely to provide a boost to the balance sheets of many financial institutions and provide some impetus again, to lending in that score. We're already seeing. As you can see, on the right hand side of this exhibit some signs of--even on the construction side where things really have been moribund that there are some turnarounds, some upturn.

We're still a way below any sort of notion of what a replacement might be on overall housing demand but it's moving in the right direction. I think the household sector has actually been looking encouraging. The business section most recently that is, I think, provided more caution flags. And that's despite the fact that interest rates are exceedingly low so user cost of capital for businesses is quite favorable and they're sitting on a huge pile of cash.

I think it's a real sign that there are still continuing concern about the uncertainties facing the many, many US businesses. Some of those concerns and some of those uncertainties are obviously arising from concerns about developments abroad and Adam and Nick are going to be touching on some of those shortly, but I think some of them reflect very much homegrown concerns.

The biggest one of those, I think, concerns fiscal policy and the fiscal cliff. I think there probably were a lot of political scientists that woke up on Wednesday morning and said, thank God for, at least, for another three years I don't have to hear the words swing state anymore. For us economists, we're looking forward to the day we wake up and we don't have to hear the word fiscal cliff anymore.

I don't think that's imminent but we're all pretty much familiar with the basic elements of the fiscal cliff. It's the expiration of the Bush tax cuts and a variety of other tax cuts, the end of the indexation of the alternative minimum tax, the end of the payroll tax holiday, the exploration of extended unemployment insurance benefits, and of course sequestration that is due to take a very significant chunk of federal spending.

How should we be thinking about the fiscal cliff? I think it's really a story of two possible cliffs. Bad cliff and good cliff or maybe one could say dangerous cliff and benign cliff. Let me start with the bad cliff. As you can see from this exhibit, if the full effects of the fiscal cliff go into place, this is a huge amount of restraint on domestic demand.

I think the CBO's analysis last spring that got a lot of attention suggested that in fact if we, instead of just doing what we've been doing, we go over the fiscal cliff, that would take one and a half percentage points all else equal off the GDP growth. Push the economy into a mild recession in the first half of next year and then some improvement later on.

That report also showed that there are dramatically different longer run fiscal implications of either continuing to do what we have been doing which will result in the continued rise in debt to GDP ratios and going over the fiscal cliff and in essence paying the price of a mild recession to put the fiscal situation on a much more favorable long-term path.

I think that led some folks to think maybe that's a price worth paying. A mild recession, a long-term fiscal rectitude. In fact, I think that's probably not the right way to think about it, and I think the reason is that going over the fiscal cliff is going to be much more costly than even the CBO's analysis suggested.

In general, if you think about the fiscal multipliers, at least as broadly construed, I think they're a lot larger now than is generally recognized and it was probably incorporated in the CBO's work which is a very sensible and reasonable piece of work. There's no doubt that being at the zero or lower bound on interest rates means that there's no capacity for monetary policy to offset any of the additional restraint that we've brought on by going over the fiscal cliff and I think Ben Bernanke made that pretty clear in his press conference, his most recent press conference. So there isn't going to be any cushioning there.

The multiplier itself is probably state dependent meaning that when the economy is weak, the effects of depressing fiscal policy are likely larger. Households and small businesses, we have probably many more liquidity constrained household and small businesses at present that would normally be the case. There's just going to be no capacity for them to smooth through the effects of the fiscal cliff and then of course the financial system itself still is not fully repaired, and I think the feedback from a significant weakening of the overall economy on to the financial system and through the financial system the real activity is likely to be much larger and then of course, there would be significant negative consequences for confidence as well.

Instead of the one point six that the CBO has assumed, I think going over the fiscal cliff, I've written something down between two and a half and three percentage points so all else equal off of growth, and the most important aspect of this is in unemployment rate, they're starting out at close to 8% now, it's got another percentage point rise.

That is a very, very different world. One in fact that looks pretty darn frightening, and I think it would be much more difficult to dig out from that. Again, I think the persistence of that short fall in aggregate demand is likely to be larger than most people think and we've already had half of a lost decade. I think going over the fiscal cliff and this manner would be sure to bake in at least a lost decade and probably then some.

I actually don't see much benefit in going over the fiscal cliff. So, what about good fiscal cliff? One argument for going over the fiscal cliff is that it immediately resets the terms of the policy debate by having tax rates move back to their pre-Bush era levels. The debate then will be about how much to cut taxes and who's taxes to cut.

That is a very different discussion than the one that we're currently having. As well on the spending side, I think sequestration, the looming sequestration would force a debate about how to have more rational cuts in overall spending. That would likely include the entitlement, but almost certainly include entitlement programs as well.

If that were all to happen, if you could know for sure that was going to happen and happen quickly, and sound decisions would be made. We'd be put on a better long-term path, then maybe that would be a price worth paying. I do think even in this scenario, the good cliff scenario, we would be looking at a weakening in overall activity relative to current expectations in the first half of next year because there's just bound to be lots of confusion and uncertainty raised by that.

But that's the problem even on the good cliff scenario. If we jump off the fiscal cliff, we're not going to know whether we're going to end up with a good fiscal cliff or bad fiscal cliff so it's one heck of a big risk to take. I can understand the attraction of that. It's quite clear that we'd all be better—I think, we'd all be better off if we avoided the fiscal cliff and took decisions to put ourselves on a long-term path.

Certainly, it may be naïve but listening to some of the comments since the elections in the last few days gives one some encouragement that doors may be open to reaching some kind of a grand bargain that avoids the fiscal cliff, that takes some decisions--some difficult decisions to put the fiscal situation on a better firmer, more sustainable path going forward.

Those are going to be really hard discussions and there are many difficult decisions to be taken, but if we were to get that, I actually think there is upside risk to this baseline outlook that I've laid out. I do think removal, significant removal of uncertainty, some sense that in fact the fiscal path for the US economy is more sustainable, could lift uncertainties and provide an even greater impetus to overall economic activity.

We really need that. There has been a lot of—this economy has been through an enormously painful period and I think there's a question about what sort of long-term damage has been done to the US economy by this long period of weak activity. I think there has been long-term damage. I think we're looking for it in the wrong places.

Let me just explain. Two areas that one often hears, is people being concerned about are labor market participation and the unemployment rate. Here's an estimate, my estimate using some research done by the labor economist at the Chicago Fed on the trend in labor force participation.

We've had a decline in labor force participation and I think it exceeds any reasonable estimate of a decline in trend. To be sure, I think the recession itself may have accelerated the departure of some folks that were already going to be leaving the labor force. No doubt, some people have moved on to disability roles as a result of the recession.

But most of this decline I believe is cyclical and I think there is going to be a significant capacity for people to reenter the labor force once demand in fact begins to materialize. The other place is the unemployment rate. You hear lots of concern about, in essence, where we experience the kind of hysteresis in the unemployment, that is a permanent effect that the short run cyclical increase in the unemployment rate morphs into longer term structural unemployment.

In fact, I think the research evidence on structural unemployment does not point to a significant increase in instructional unemployment in the US. There has been some evidence that as the unemployment rates fall and vacancies have increased even more rapidly, what economists would call on outward shift in the beverage curve, but I think that's a pretty typical cyclical pattern because businesses can find it easy and less costly to adjust their vacancies and then alter their recruiting intensity.

They can post the vacancy, but they can alter their recruiting intensity so I don't see that as a sign of significant structural problem. Same thing on sectoral mismatch; I don't think there are some evidence of—but the kind of concerns that people had early on that we were going to fly giving that the shock started in construction and finance. That that was going to lead to a significant sort of increase in structural employment of those workers I don't think is in evidence either.

House lock I think--there was a concern that maybe homeowners would not be able to geographically move because they'd be locked into a house with a mortgage that was underwater, but research by Rob Valletta at the San Francisco Fed and other researchers as well have shown that in fact unemployment durations for owners and unemployment duration for renters in areas where house prices have gone down significantly are just about the same.

I don't think this is likely to be the area and I think we ought to be able—as you can see my estimate had some increase early on in the recession. Part of that was the effect of unemployment insurance benefits which I think probably did temporarily boost the [Inaudible 00:27:19.8]. I think there has been some evidence of a decline in employer and employee matching, but I think that is most likely to fade away as the economy slowly begins to improve.

But the pain that we are likely to see persist from the great recession in terms of labor market is going to be on the earnings profiles of those people that have been hit by the recession and the subsequent slow improvement in the ongoing long periods of long-term unemployment. Those people are likely to be disadvantaged both now and for a very long time in their overall earning profiles.

Young people just coming out of school or people that lost their jobs mid career are going to, I think, need to adjust down the reservation wages and that's going to happen. One of the differences between United States and certainly Europe is our safety net is a whole lot thinner. I think it is the case that people in fact do in the United States adjust down their sort of earnings expectations, their reservation wages over time.

I think what we're going to have is an unemployment rate that will go back five or six percent but with a lot of people who've suffered very long-term income consequences as a result of the recession. One final note on how the recession has probably affected the US economy is there's no doubt that the weakness in business spending has shown through.

Well we've seen some rebound in the growth of the business capital stock, it's still pretty meager and after a sharp increase in productivity during the recession, productivity growth has moved back quite substantially. I think we're probably looking at an economy that can only grow, let's say 2% at least through the next half a decade with maybe one and a half percentage points of that coming from productivity and half a percentage point from labor force growth.

I think the most serious thing that we can do to support the supply side of the US economy is to make sure we're fostering sufficient aggregate demand which I think will in fact bolster our capital accumulation and will improve labor market outcomes I think that is still the most—if we're looking for the most sure fire way of improving the longer run prospects of the economy is to attend to the short run prospects. I'll stop there.

Adam S. Posen: Well, if I can be allowed, just a personal note, it's good to be home. Thank you. Lots of [Inaudible 0:10.6] line, it was sincere. I'm very grateful to Carla for doing such a wonderful, warm welcome as well as chairing this session. Fred Bergsten had to be away for a family reason but he's sending his regards of course here in the Bergsten Conference Center.

If I make one more sort of institutional note, I am very proud that my first hire, our first hire now is Dave Stockton. I think you all just saw why and this is—we saw last week, we had two marvelous fests celebrating the careers here and throughout of Morris Goldstein and John Williamson who contribute so much both to the institute but also to the global economy.

Those people are never replaceable but the institute continues to grow and thrive and we are getting our new generation in and there will be a couple more exciting new scholars who will be introduced to you over the first half of 2013. I look forward to doing that, as Carla said from this stage. Back to substance, my title, Euro is Going Nowhere in Two Senses is pretty straight forward.

A, the Euro is going nowhere, the Euro is not going to disappear, the Euro is not going to break up and go away in a way that I got used to hearing constantly in the city of London over the last few years but B in growth terms, the Euro area is going nowhere also. It's going to completely stagnate, maybe have some mild growth in my opinion, but probably have near zero for the next couple of years with obviously that being mild positive growth in Germany and pretty horrible ongoing recessions in the periphery.

Bottom line, that's the two points I would make. To expand on that why do I think this is happening, what's going on? Well, we're looking at the two year horizon and the two year horizon is dominated by macro policy. We have a macro policy situation where the ECB has, I would say finally, stepped up and provided some conditional ease to the Euro zone and stopped, to some degree, a panic in the sovereign bond market and that has put a floor on their growth.

At the same time, we have large number of governments, perhaps with very good motivations but with bad effect pursuing very strong austerity programs simultaneously in a currency area; and that puts a very low ceiling on growth. There are other factors there, there are structural factors, there are banking factors, and there are confidence factors, I'm happy to talk about all of them.

But the dominating message I want you to take away today is policy right now which is very unlikely to change in any meaningful way in the next year at least, is bracketing Euro area prospects. From the US point of view, from the global point of view in some ways this is good. We are not going to be seeing the kinds of idiosyncratic shocks coming out of the Euro area, the kinds of uncertainty and general problems of transmission that we had to keep facing or fearing over the last two years.

Sitting there at the Bank of England as I was doing until three years ago, there were two periods, you could probably guess when they were, when I felt like I was one of those British Tommies in a World War I movie; strapping on my tin helmet waiting for the balloon to go up, as the saying goes, and go off to fight the good fight for no purpose if the Euro zone went kablooey.

I am reasonably confident, and I wish I could be confident of more than this, but I'm reasonably confident we're not going to have a kablooey in the next two years. That is good news, reduces uncertainty, but we should not be happy about that, is what we've ended up with. So, to expand just briefly on those points and I will throw in some numbers, I think that the place to start is just to recognize that macro policy is still powerful.

There was a very nice FT Op Ed the other day but I think Bruce Bartlett talking about the pointlessness of macro policy. I admire Bruce's bravery in telling truth about taxes, but on this one, I disagree. You can just see this within the Euro area. So, the red line, the red bars are the ridiculously low interest rates that were being charged to periphery countries on their bonds prior to the crisis.

The blue bars are the spreads or rather the interest rates that were being charge by these government countries on their government bonds in the height of the crisis or in the middle of the crisis. The green bars are the, what's happened since the ECB made its commitment. Putting it a little more clearly is the time series, there are some anticipation in financial markets but just, is there a thingy on here?, No, that was the wrong thingy. Okay.

This is the thingy, thingy shut off. No, there it is. Okay, you see this? That doesn't look like much considering where Portugal was. That's 120 basis points. Right here, the blue line Spain, that's over a hundred basis points. These are very, very substantial movements in official sector rates when nothing fundamentally changed, just the ECB stepping up.

This is a very big deal. I will return to the question of could they have done more and could they have made a bigger deal? But macro policy here works. Now, we can also talk about the fiscal commitments and I will get to that in a moment. But, what is important to recognize is that we have consistently, when I say we, I don't mean me of course, I mean the economic community, economic policy community, the people in the Central Banks, the people in the forecasting business, have consistently underestimated the multipliers on fiscal policy in the recent times.

Just now, thanks in part to the leadership of the IMF on this issue, thanks in part to some independent voices many of you know, I was one of them. We've been out there saying, come on, whatever your ideological disposition, whatever your concerns about the future, long-term debt levels which are legitimate.

You can't deny the reality that when interest rate is at zero, then the economy has lots of slack. When there are financial disturbances still in the system, that multipliers are going to be greater than one. Yet policy makers in 2010 and 2011 to a surprising degree did just that. That's part of the reason frankly why forecasts were wrong and policies were set wrong.

Again, this is not to say we never have to pay off the debt. This is simply to say if you're going to make realistic forecasts, if you're going to make realistic policy pledge, you have to take into account what really happens. Now Dave had mentioned during his talk, and I know he's thought about this deeply, some of the reasons why that—beyond that list I gave you why multipliers are going to be particularly big right now.

In the Euro area we have one notch further which is you have a bunch of tightly tied together economies doing it all at once. Now, this is pretty simple algebra and it's certainly far from optimal. Because instead of having a spillover, your policy dissipates, excuse me, we have a reinforcement of your policy and you even have a competitive aspect, there's at least ugly contest.

I want to prove I'm not Greece. No, I want to prove I'm not Greece. Well, I certainly am not Greece. Suddenly, everybody is doing extremely rapid consolidation. Now, my colleagues, there are a number of people in this building as you're well aware who work very well on Europe and particularly we all need to recognize that Jacob Kirkegaard has become to Europe with Nick Lardy as to China.

Everybody's go-to person and deservedly so and Jacob will tell you that there is real structural reform going on in these countries arguably as the result of the tight pressures enforced by these policies, and our other colleague, Anders Aslund has been out there arguing something similar pointing to the example he's done some very interesting work on Latvia and how that has worked in Latvia.

Occasionally, I'm not going to quote these people but you will—my dear colleagues, you occasionally get people with a variant of what they have called the benign cliff. This is a good thing. This is getting us forward. Well, we can debate the merits of it. I'll get to that if people like in the discussion but as a forecasting matter, let me reveal to you the dirty little secret.

These structural reforms will not yield any benefits unless there is a recovery in the Euro area. When Germany reformed its labor market in 2003, 2004 and they did so bravely and radically, and they did get lower long-term unemployment as a result, but they did not see the benefits until there was a global recovery and growth was above potential in Germany.

If you keep going with your structural reforms in a period while you're defeating any chance of expansion, then you get the labor market problems that Dave was talking about. This is a chart of the youth unemployment rate and I should've labeled 100 minus unemployment rate means the participation, the decline in the participation rate.

These are changes. The youth unemployment rate as we all know in Spain is hideously high. We can tell all kinds of stories about how it's not so bad to sit out in Málaga and your family looks after you but the income scarring, the professional scarring is for real. These are all numbers that are simply extraordinary, okay?

Minimum of 12% rise in youth unemployment. Now, many of you are familiar with these figures, but I want you to just get in your head what the scale is. So, if Dave can rightly in my view, raise the issue of what is the long-term damage to the US economy, to US labor force, to US growth prospects from an unemployment rate of 8%, a youth unemployment rate of 15%, what is the damage to these countries?

Similarly, participation, the chart they have showed you if you went down that trend from Fed Chicago, you're talking about participation rate drop in the US of what, two, two and a half percent? Okay, the smallest on we're talking about here is Italy at just under two. Portugal is five. Ireland and Spain are 8%, 9%, 10% drops in participation.

This is extraordinary and this is the reason why I fear that most forecasts for both potential in the Euro area and forward going growth in the Euro area are still too optimistic even if you will allow the tail risk which I believe the ECB has at least for now, done. I got a bit more here on fiscal policy.

I'll skip it over for the moment, get to a nice blank slide so I can go to the next point. One thing why I want to give Jacob and Anders among others credit although they are among the very few in the US who saw this; was Jacob and Anders were out in front saying the political sustainability of these kinds of austerity programs is going to be much higher than you expect, and they were right.

A number of us, myself included, thought, riots in the streets in Athens, protests in Madrid. How long is this going to go? Well the answer is, quite a while. The answer is some of these places do reelect parties that are center right, not radical right, not horrible, who do want to actively continue austerity and that means however, that just because it's politically sustainable does not mean that it is beneficial.

And just because it's politically sustainable does not mean that it's inevitable. So what you're getting is large sections of populations in these countries that are becoming disenchanted, disenfranchised, thankfully it is not the 1930s. We do have welfare states in Europe, we do have the discrediting of racist and other policy so the people who spun out the nightmare scenario, "oh it's the 30s again," exaggerated.

But they exaggerated the pace. They didn't exaggerate the nature. Just remember, if it took Germany to get into political trouble as a result of exchange rate and force austerity in the 20s and 30s, it took five to seven years before the elections of 1933 wherein you're really three for most of these Euro countries possibly four for Ireland.

So, coming back to the forecast real quick. I'll defer to our friend Minister de Lecea from the Delegation of European Commission, they just issued and there's a nice reprint of the chart from the Wall Street Journal yesterday, the official forecast and they quite responsibly though sadly marked down quite a bit for the Euro area and for particularly the periphery countries.

I go for the reasons I said, a little bit further. I think that the Euro area as a whole and that it's going to grow at about 0.5% for 2013 and 1% or a little less for 2014. This is because I think the official projections which are among the more reasonable of official projections underestimate the depth of the coming recessions in Italy and Spain or the persistence of them for the reasons we talked about.

I think in that means that in Spain in 2014, in Italy in 2014, we're talking out a recession of more in the order of minus 2% in Spain and minus 1% in Italy instead of a full percentage point higher roughly which is what some people are forecasting. I think it also remains a bit optimistic to think that Germany will return to a 2% growth rate at 2014 which is what the European commission currently has.

Nick Lardy is going to talk a bit about why there may be a short-term continued slowdown in China. In that kind of world, it's very hard to see how Germany sustains. What happens in honor of Fred Bergsten, to the exchange rate? Well, the Euro now becomes essentially instead of a source of exchange risk I guess something buffeted by exchange rate risk.

For the next couple of years, I think it will frankly be trading at a much smaller range for based on its fundamentals, the 1.3 roughly where we're at now is probably a little high from a competitiveness point of view but as long as there are successful financial repression which is what makes the whole thing sticks together, that will put a floor under the currency unless, God forbid, we get the fiscal cliff, the bad fiscal cliff that Dave talked about and that Europe is demonstrating for us.

There are some risks obviously as forecast. On the upside, I would emphasize three. As a number of people pointed out and as Bill Cline has pointed out particularly with respect to public debt sustainability, Spain's fundamentals going into this crisis were quite good. Obviously, unemployment, labor market was not perfect but you look at the actual productivity growth, the state of public finances, the strength of the main banks, not the small banks, not the cash house, but the main banks, the export competitiveness, Spain was a good economy.

And so there remains always the hope and the possibility that if the rest of Europe were to cut Spain a bit of a break, Spain could come back strong and to a lesser degree you can argue that for Ireland. Ireland it really is, you have to get rid of the pernicious debt and we don't know whether that's going to happen or not.

A second possibility which I put a low probability on is that the ECB takes their conditional commitment to do their so-called OMTs to intervene in markets of governments that have undertake a program and runs with it and does it very aggressively. I would put the odds at this extremely low even though President Draghi there is finally saying some things about the fact; maybe inflation isn't really a threat.

The third possibility and I'll refer to my colleagues Nicholas Veron and Jacob Kirkegaard about this and as usual in best IE form you can hear them debate it is whether the banking union becomes a form of real mutualization in fiscal transfers in the near term and that's very contingent on the German political situation.

Again, I'm happy to comment on that and I'll simply say it's a matter of forecasting the odds of us getting, except for a one time goody for Ireland. Any bank mutualization in the next two years I think are very low, and if we don't get that then you're not getting the necessary fiscal transfers or bank bailouts.

You're not breaking the sovereign bank law. Downside risk I've stressed the good news that I think a lot of them been taken away, that remains the possibility that Greece--something really messy happens in Greece and the redenomination risk runs riot, I have to believe if there's any sense in financial markets and I've got a few sensible friends out there, the only people with money left in Greece are poor people in Greece.

There is also a possibility as I have discussed with some colleagues here that if Spain goes into a program particularly since they have a lot of money to roll over in the early part of 2013; that there could be some mess up of the hand off either between the ECB, the IMF, the Commission of the Troika. I put a low probability on that, but I think that, if you want to look for an event risk that's the moment to look for an event risk.

Let me conclude Carla at my bidding not realizing how long-winded I would be, suggest that we might say some things about US challenges. I will be very brief on that and happy to address it in the session. I think the US has much less to fear from the Euro area and from Euro area problems now and going forward than they did for the last few years.

The last few years it was a serious matter, now it is an unfortunate matter but not a serious one. That, for those of you long enough remember, have long enough memories will recognize that's Japan. It ends up being Japan of the 90s. It ends up being a drag. It ends up being something that interferes with activist, global diplomacy in the economics field because a country that, for all its problems on balance is usually a partner for market, a partner vis-a-vis China, a partner of vis-a-vis rest of the world is not just activist and is if anything tooling up a bit it's mercantelist to its ways to try to get some growth.

The sad thing is without over crisis and financial vulnerability, you're not going to pay that much attention to a decaying, declining country and in Euro area it is not a decaying, declining area but when everybody talks about China, and everybody talks about pivoting to the pacific, this will reinforce that trend.

That is unfortunate for the values that Europe and the US share in the economic and other spheres. What can you do about it? You have good friends here from the State Department, the White House, the Fed and they've been around long enough to know that when a rich country over whom you have no leverage is on a self destructive path, all you can basically do is keep working on them, trying to persuade them that they're doing something wrong and this is the place where the Obama administration I think does have a challenge which Congress does not that much of a role in. You may have to pick winners.

You may have to decide the person in that party in Germany or that party in France really does have more sense than the person in the other party. That was a big thing we did with Japan in the early 2000's. I worked with Glenn Hubbard, who was then at the Bush CEA and we reached out very strongly to Heizo Takenaka working for then, Prime Minister Koizumi which was one faction in the Japanese system.

And the fact that Koizumi and Takenaka came in and then appointed Fukui at the Bank of Japan led to a reversal bad policies there and that led to, even though nobody seems to remember, very solid growth in Japan from 2002 to 2008. We may have to, at that level of diplomacy, be thinking about who you're backing, who you're siding, with, who you're encouraging in Europe because the alternative is stagnation and decline which may not be anything that's going to get you up the top of the president's agenda but we don't really need Europe slipping to the bottom of the president's agenda.

Thank you all very much.

Nicholas R. Lardy: Thank you, Carla, for introducing us and sharing today's session. I'm delighted to have a chance to talk about China and the outlook for China. I think the key question that has been in the air for quite some time is whether or not China is going to have some kind of a hard landing or whether or not it can avoid that.

I'm going to address this really looking at a medium and even something close to a long-term context with a long-term framework about what's the best way forward for China to avoid a hard landing and what are the kinds of policies the new leadership—which is going to be announced next week—what are the kinds of policies that they should be looking at.

Well, everybody remembers that a couple of weeks ago the Chinese announced their quarterly GDP growth and a year over year basis, and we had the seventh consecutive quarterly decline. We're down to 7.4% compared to a peak of over 12% in the first quarter of last year, so that seems like a very—the bearers basically think this is going to continue and drag growth down quite a bit further.

The optimists, on the other hand, take the same numbers and look at them on a quarter over quarter basis and they say actually, you know, we're past the bottom. The worst was in the first quarter of this year and the last two quarters have had a bit of an uptake. So if you're looking in this framework of a Q over Q basis, things don't look quite so bleak.

But I would say, and what I'm going to talk about, I think there is still an ongoing debate as to whether or not the upturn on this quarter over quarter basis can be maintained going forward. Even when you look at this basis, it's fairly clear there's a significant slowdown in economic growth over the past couple of years. And I want to suggest it's really due to two factors: the external environment and the domestic investment environment.

On the external side, China's export growth has slowed very, very dramatically. I think you can see here, this is quarterly data on a year to date basis. So reading the numbers, exports were growing at 30% in 2010, about 20% last year. But year to date, that is growth and exports in the first three quarters of this year compared to the same period of last year, is only 10%. So it's a very, very low growth and currently the external sector is actually subtracting about a half a percent of growth of GDP in the first three quarters of this year.

Most of this, no surprise given what we just heard from Adam, most of this is a decline in exports to Europe. Europe is China's largest export market. Again, this is showing you data on a year to date basis. So, year to date, it's not just that China's exports to Europe are growing more slowly than they used to, they're actually down between 5% and 10% in absolute terms, and based on Adam's analysis I would agree there is very little prospect of a recovery in this any time soon. So, certainly the external side is one of the sources of slowdown in this economy particularly over the last year.

The other source of slowdown is that investment growth in China is slowing, moderating, primarily because investment in property has been softening. And you can see it again, the data here on a year to date basis, property investment grew 30% in 2010; over 30% actually, just under 30% in 2011. But on a year to date basis in the first three quarters, property investment is only about a little over 10% for residential property. It is 10%. So that's a very, very sharp slowdown.

This has had obviously significantly adverse consequences for other sectors of the Chinese economy. Take steel, for example, 40% of China is producing about 700 million tons of steel a year. You probably heard me say this before. They're producing more steel than the next largest ten steel producers combined. 40% of that goes directly into property. And in 2009 and 2010 when the property sector was booming, steel was—output was growing at about 15% per year, moderated to 10% last year, and in the first three quarters of this year, steel production has basically collapsed. It's growing at less than 2%. And the entire sector is now losing money at a very rapid rate.

Now, property investment has become, over the last five, six, seven years, the single most important driver of China's economic growth. So I think understanding the reasons for the slowdown in property investment is a key prerequisite for trying to understand what the Chinese economy is going to look like going forward. Is the pace of property investment likely to recover somewhat? Maybe not go back to 30% which is probably unsustainable, or is there some prospect it will continue to soften.

Now for quite some time—some of you have seen this diagram before—for quite some time I have believed that investment in property, particularly residential property has been driven by financial repression as reflected in this diagram which shows you negative real deposit rates in China on average since 2004. Also major restrictions on capital account convertibility, and an underdeveloped capital market. So what we've seen is more and more people are going into property as an investment and that has driven property investment as a share of GDP into the stratosphere. China is not only way above countries like India and Taiwan that never had property bubbles, at least to my knowledge, but even well above Spain and the United States which clearly did have property bubbles. So China is now at roughly 11% of GDP going into residential housing.

I mentioned that I think it's mostly for investment. In other words, lots of people are buying houses not to live in but as an investment, and this is the result of a very interesting survey released earlier this year in China which shows the extent of ownership of multiple properties by people in urban and rural areas. You can see in urban areas about 15% of the households have two properties, maybe 4% have three or more properties, and the red line shows you that on average, the ownership is 1.22; that is one out of every five households has two properties. And one surprising thing from the survey was this phenomenon of investing in property is not restricted in urban areas. Even in the countryside, about one out of seven households have a second property. This has been a major, major driver of property investment and one of the reasons we've gotten up to 11% of GDP going into housing.

My view for quite some time is that it's unlikely that this high rate of demand for investment property can be sustained indefinitely and when it waned it would drag down China's growth, and I think we're seeing some evidence that that is the case. There was a recent survey by China Merchant's Bank, one of the more progressive banks of high net worth individuals, and you can see here over a two-year period, they're cutting their investment in residential property. They're going into other kinds of assets, alternative investment. Wealth management property is a little bit more into equities, but property is going down. So the appetite for property among these households is diminishing.

Second factor I look at is household indebtedness. And you can see in this diagram that household that relative to disposable income jump very sharply in 2009 and 2010 when the property boom was its most intense, but has grown a bit more moderately in 2011, and also although I'm not showing it in diagram, but also in the first three quarters of this year.

So, maybe the appetite for multiple property ownership is moderating, and you'll see particularly in the black line that mortgages as a share of the household disposable income actually began to come down in 2011. Indebtedness of households in China by US or UK standards, of course, 50% is absolutely nothing. But this is a much, much higher level of indebtedness than you will find, I believe, at any other emerging market. You look at countries like the Philippines, Indonesia; you'll be looking at numbers like 9%, 15%, not 50%. So maybe the appetite for more debt on the part of households is beginning to moderate. This is another indicator that perhaps property cannot continue to be the driver of growth that it has been.

Similarly, when I look at the composition of household wealth over a period of a little more than 10 years, you can see obviously people have bailed out of bank deposits because of the negative returns, and they've grown very heavily into property. Property now comprises 40% of household wealth, a little bit more than twice what it was in the late 1990s. So again, the question is, is this going to continue to increase? Are we going to have 60% or 70% or 80% of household wealth in the form of property? It seems unlikely to me that eventually households will want to hold more diversified asset composition.

And finally, I'll just look at it from the point of the banks. Again, the red line is showing you loans to property in the form of mortgages and loans to property developers as a percentage of the bank loan book in China. It has went up pretty dramatically in 2009 and 2010, leveled off a bit in 2011, and is coming down a bit this year. Again, this suggests that banks are beginning to manage their risks more vigorously, that they're overexposed to property. You can see exposure to property was peaking out at 200% of bank capital which means if there's any substantial adjustment in the property sector, banks would be pretty vulnerable.

So, I guess the final question I'll address is, if property investment is going to moderate going forward, it's not going to stay up at 11% or continue to rise but maybe begin to come down, what are the possible offsets in order to sustain growth at a reasonable level. Well, this is a diagram you've seen before. This is the long-term structural problem that China faces. Investment, particularly from the middle of the last decade on, grows pretty relentlessly reaching a peak of about 48% in the past two years that is in 2010 and 2011, and the consumption share of GDP has had this long-term slide. So, clearly the challenge is reversing this. If investment growth is going to slow down, if consumption growth does not pick up somewhat, we'll have a very substantial decline in China's GDP growth.

I've talked about some of these policies in this room before. I'll go through these very quickly. On the exchange rate front, China has dramatically reduced its intervention in the foreign currency market. It was averaging about 450 billion a year in 2007 through

2010, dropped at 350 billion last year, and is only running at about a hundred billion so far in the first three quarters of this year. So, the first recommendation is that China should further reduce its intervention of the market and allow the RNB to be fully market-determined. The second is to further financial sector reform, accelerate financial sector reform, particularly the liberalization of deposit rates so there's not such a heavy tax from financial repression on the household sector. This would boost their income and contribute to the growth of consumption. They did take a small step in this direction earlier this year but it was very small and there hasn't yet been any followup.

Eliminate subsidies for industrial energy consumption. China's consumption of energy is very, very different from ours. Fully 75% of all electricity is consumed in the manufacturing sector. The generating companies, the distribution companies, are losing vast amounts of money. Basically the manufacturing sector is being subsidized just as it's being subsidized by the evaluation of the exchange rate. This is tilting investment into manufacturing out of services, reducing the rate of growth of job creation since obviously services is more labor-intensive than manufacturing. Reducing the rate of growth of wage income as a shared national income below the path that it otherwise might take and thus leading to lower consumption.

And finally, they have made some progress on building out the social safety net in order to reduce the precautionary demand for savings. Household savings rate in China is still in the stratosphere and if the social safety net were built out along with interest rate liberalization, there's a very good chance it would come down.

Well, I'll just conclude by looking at a couple of rebalancing scenarios. How do you get from this highly imbalanced economy with too much investment, not enough consumption to the other way around? Quite frankly, these are just schematics design to make a few points. The bearish scenario is based on the idea that you should cut the rate of investment, the growth of investment, fairly rapidly and that this will also have an adverse effect in consumption. Hard to keep consumption growth up if your investment is falling quite rapidly. And you can see what happens here is that this leads to a relatively low GDP growth, something in the neighborhood of 5%. And ironically, even though you're having a very slow growth of investment, you don't get very far in rebalancing. The investment share remains in the mid-40s which is way too high.

The bullish scenario involves a significant but somewhat slower path. A significant but somewhat slower rate of decline in investment and the adoption on policies to encourage private consumptions or consumption growth stays a little bit stronger. And obviously, in this scenario, you get much higher GDP growth and you get much more rebalancing. The investment share of GDP falls to 40% or a decline of almost 10 percentage points. Now, obviously the intermediate case is kind of muddling through. Slower GDP growth in the bullish scenario. Still significant rebalancing.

The last column is showing you where housing investment as the share of GDP would be coming to in the three scenarios. Well, taking it back to the leadership transition, I think if Xi Jinping-Li Keqiang leadership does push strongly on economic reform, the bullish outcome is within reach. We've already seen in the last two years that consumption—go back and look at this diagram very carefully, you can see that consumption growth actually ticked up a bit last year, and it is the case that over the past two years, consumption is growing above its 10-year average growth rate and investment is growing below its 10-year growth rate. So we're already seeing that there is some rebalancing and the relatively more rapid growth of consumption is helping to soften the slowdown in GDP. Remember, GDP growth last year was 9.3% which was not bad given the slowdown in investment that occurred—not the decline in investment as a share of GDP but the more modern growth of investment.

So, I think the bullish case is within reach if they push ahead on some of these rebalancing policies. A lot of commentators are very pessimistic and I have been pessimistic in the past as well. Lots of vested interest will not support structural changes that have advantaged them. The current system has advantaged the manufacturing sector at the expense of services, the inland—the coastal areas at the expense of inland, borrowers at the expense of savers and so forth. But I think the likelihood is actually that vested interest will be forced to give way once there is a consensus, that the alternative to undertaking more serious economic reform is a prolonged economic slowdown, and a slowdown that would probably take China's growth down into the four, five percent range. And even though different interests have very different perspectives, I think everybody in the top leadership in China and various sectors, regions, and so forth, does share the view that the legitimacy of the party is based very heavily on sustained economic growth, and when the alternative is that that's going to fade away, some of the vested interest, I hope, will give way, will have more significant economic reform, and will get China growing at 7% to 8% on a sustained basis going forward with a much more balanced growth pattern and much less emphasis on heavy industry and investment as a result.

Thank you.

Question and Answer Session

Carla Hills: And so now it is your turn. We have roughly 20 minutes to direct your questions. I would ask you to approach the microphone and to state your name and affiliation and direct your question, or if you want to leave it open we'll let the panel address the issue. All right, the gentlemen that's first in line.

Jamie Strawbridge: Hi, thanks, I'm Jamie Strawbridge from Inside US Trade. I had a question for Dr. Lardy on engagement with China on economic issues. I'm just wondering if you could elaborate a little bit. I guess part of it is due to the campaign season but there has been a lot of tough talk on China from both candidates, also the United States has brought a series of World Trade Organization (WTO) cases against China this year. For instance, and we continue to push them on a range of economic issues that are priorities for us.

With the new leadership coming in in Beijing next week what advice would you have for the second term Obama administration? Is it wise if we are trying to get them to do what we think is in their interest and ours? Should we kind of now step back, take it easy on the WTO cases, you know, let this leadership come in? What is the smartest way to approach this, that they have the space and willingness to undertake some of these economic reforms? Thank you.

Nicholas Lardy: I think the Obama Administration's approach to China was basically pretty good. I think, as most of you know, President Obama had more direct one-to-one meetings with President Hu Jintao in four years then President Bush had with his counterpart in eight years. There has been a lot of face-to-face discussion of strategic deal political level and I certainly hope that will continue.

But the other thing this administration has done is to bring a lot more cases, as you suggest, and they didn't all come in the last year, it's been building. And we have brought a lot more cases against China for what we think are areas where they are not living up to their obligations. I hope that will continue as well, because I think the good news that we can say after 10 years of China's membership in the WTO is they accept the legitimacy of the dispute settlement process.

They understand now how it works; they bring a few cases when they think other countries aren't living up to their obligations. They are the subject themselves of quite a few cases. They don't lose all of them, but they lose more than half, I guess. Carla probably knows the numbers down much more precisely.

But the very good news is that when China loses a case it generally complies with the ruling of the dispute settlement panel, which is, quite frankly, better than you can say about the United States.

So, I think, and a lot of people think, this combination of high-level strategic engagement and down in the trenches on trade is counter-productive, but I think the record of last few years shows that, it was started a bit by President Bush, but I think under Obama it accelerated. I think it is the best way to keep the engagement and try to enforce or try to get China to live up the obligations it made when it joined the WTO a decade or so ago.

Carla Hills: And if we want China and others to do that, it will be important for the United States to lead by example and to carry out the obligations it has under the WTO. Jessica, you had a question.

Jessica Einhorn: Jessica Einhorn, Peterson board. I also wanted to ask Nick so it's on the distribution here. But I have been looking for a while with your pointing out that what we need is to shift from investment to consumption. And the point which certainly resonates in places like United States and Europe is that that would be greatly supported and even come about faster given momentum if there were safety nets.

And today I found myself asking; I wonder whether the political culture of China is such that people would give up their personal savings on a bet that 20 or 30 years from now their government would be there to support them? Or whether in fact it is not a straight line in terms of people moving from savings to consumption, even when a government steps forward and says; "We'll be having this safety net for you."

Nicholas Lardy: Well, I very much agree with the thrust of your question as people don't change their savings behavior based on promises that they are not sure will be fulfilled. But if you look closely at what's happened over the last four or five years, China's government has done a great deal. They have rolled out a medical insurance scheme in the countryside that is voluntary. You don't have to belong and if you want to participate you pay a relatively small amount, like a couple of dollars a year.

And it is not gold plated coverage but the reimbursement rates are running at something like 50, 60, 70 percent, and as we saw this rolled out over the last few years the rates of participation are like 95 percent. In other words, if you go county by county, because it is run at the county level, once the program is up and running, people see a neighbor that got some coverage, they sign up.

As I said, the participation rate for that is over 90 percent, so at least in the health area. And China has never had any health insurance schemes in the countryside. And as I say this is not a gold plated system. It's nothing that we would want to have as our insurance scheme, but if you have been in an environment where for centuries there has never been any health insurance in the countryside, it is a big step forward.

So, I am still optimistic that there is some traction on building out the social safety net in terms of the impact on savings. It won't appear next quarter or the quarter after but I think it is coming.

Carla Hills: At the microphone.

Qung Qhwe Vu: Thank you. Qung Qhwe Vu, with the China News agency, Hong Kong. Yesterday in the party congress report, President Hu Jintao proposed a ten-year perspective of doubling China's GDP and per capita by 2020. What impact do you think it will have on US-China relations and global systems? Thank you.

Nicholas Lardy: Well, I think quite frankly, not very much, because China on these five-year party meetings has frequently tossed out these numbers; like we are going to double GDP, and doubling by 2020 actually is not actually a very high rate of growth, it is below the average rate of growth of recent years. So I think it is a good slogan to give at the party congress, but operationally I am not sure what significance it has.

I think if China does the kinds of policy reforms that many people in China have been calling for they will easily be able to meet that goal. It will be a plus in terms of their relations with the United States and I think with the rest of the world. We'll all be better off if China grows more rapidly rather than falling into a multi-year slump which is the bearish case.

Antonio Dethayer: Antonio Dethayer, European Union Relations here to the United States. You may expect that this question is addressed to Adam. And indeed we agree on much, but we disagree on some as well. And particularly the titles of your presentation and one of the European commission forecasters you refer to are quite telling in this respect. You presented it as going nowhere. The title of the commission forecast is Sailing Through Rough Waters.

So we are sailing, we are going somewhere. And knowing yourself from the past, I think I may have misunderstood in the sense that I thought you said the fact that there had been no tail risk, that there had been no breakup was not to be happy, I am sure that is not what you meant.

Adam Posen: Just a sec. What I said was, "That should not be enough to make us happy."

Antonio Dethayer: Okay, thanks. My second point is we are indeed in very troubled waters. The crisis was the consequence of at least four storms; the fiscal one, the competitiveness one, the financial, the banking one and institutional one, so the unfinished architecture. And we are working on all four fronts simultaneously because we know there are interactions amongst themselves, therefore we cannot just provide for an optimal sequence, we must address all of them well ahead.

So, and that makes things more difficult. I mean we understand, and particularly the multipliers have—I mean, reflect on that. And the multipliers have been high partly because of the confidence effect they can be traced to the financial markets, very largely, and to the client and domestic demand.

But what we are trying to do is reverse all that negative multiplier and the vicious circle into virtuous circle. So by addressing all that at the same time. And we are seeing that this is very good, so we see competitiveness that is increasing, we see exports in the distressed countries that is increasing.

True, we need some more demand and we are trying to give that through more investment from the EU budget and using better EU transfers. So this is a way that we would be sailing. We would be sailing to a sustainable, certainly low growth in the short run, but much, much leaner economies and much sounder, both growth and public finances.

Yes, the question now is, you said that we shouldn't do this, we shouldn't do all that at this expense, but frankly, with the constraints of the financial markets which are not the same as those in the United Kingdom that you know well now and those of the United States, we are forced to do that quite quickly. So, what is the alternative option, what is the alternative path that you would propose?

Adam Posen: Just quickly, Minister de Lecea and the delegation of the European Union here has long time been a friend of the Institute and we hope the Institute has been and continues to be a friend to the European Union project and so I am glad you made sure that I was not misinterpreted.

But friends have to be honest about the short-term and what's going on. And so my forecast was not based on giving a handicap for difficulty. So, if I was evaluating the contribution of various European policymakers, I would definitely say they are under a much bigger handicap than say some of our counterparts in this country or some of my counterparts, former counterparts in the United Kingdom.

But this meeting is not about that, even if I would say to the commission is playing a much more constructive role than some of the other members of the troika and players. That said, just to quickly come to a point, does one have space, do you have fiscal room to do this more slowly and do this differently?

I believe yes. So there were two charts that I didn't put up, one which shows that the feedback is from slow growth to budget deficit. So if you accept the idea that the markets are responding, for the most part, to the fiscal situation, which is not entirely obvious, but say that is true. It is a legitimate empirical question, at what point you get diminishing returns, because by what you are doing to growth overwhelms what you are doing to increase revenues or decrease spending.

And I would argue, and this is in the spirit of what DeLong & Summers argued in their Brookings paper and what the International Monetary Fund (IMF) have started saying and I was warning about this internally in Europe off the record the last few years, I would argue that we are at that point.

Now the commission has issued box 1.5 in your autumn forecasts on discussion of this point and I look forward to debating that in more detail, but to me the evidence is quite clear, particularly if you look at Spain, the feedback is from slow growth to eroding fiscal position, not from eroding fiscal position to slow growth.

The second point is; we shouldn't pretend that the markets are on a knife edge, leaving aside Greece, Greece is obviously a special case. We are not seeing capital flight in Europe. And the times I mentioned when some of us in the United Kingdom and elsewhere were quite terrified is when we started to see things that looked like capital jog out of Spain or Italy. And that was driven very much by banking system developments, not by economic, macro developments.

And so, given the fact that the European Central Bank (ECB) has basically created, replaced the interbank market and there is no real evidence of capital departure from Italy and Spain, I think you can get away, frankly, with going more slowly. Particularly if it is coordinated so it is not about; "Oh gee, look France or Spain or Austria or whoever, pick your country is not playing along." I think a coordinated pull-back by the European member countries—the URA member countries, excuse me, and would be right.

Danny ShiFonguo: Thank you for doing this. Danny ShiFonguo with Shinqua News Agency from China. Two questions: In the United States firstly; if Obamacare and the Frank financial reform are two biggest legacies for Obama in his first administration, what might be his biggest legacy in the second term?

Secondly; can Democratic and Republican lawmakers make good use of the fiscal cliff negotiation to push forward a big round of a grand bargain and a tax reform? Thank you.

David Stockton: So, those were two questions, but actually I think they have the same answer which is; I think the biggest legacy that President Obama could look for in his second term, obviously preserving both the financial regulatory reforms and the reform of our healthcare system. But on the second term I think actually putting in place a credible and clear plan for long-term fiscal consolidation would be an extremely valuable long-term legacy.

I think that is one that is within our grasp. Not to in anyway downplay the difficulties here, but I think that is also plays into Democrats and Republicans if there was, certainly from the polls, the evidence suggests that American people really want to see some action here. I know there is skepticism about whether or not their enthusiasm for that will wane quickly once they begin to realize that there is actually some pain involved with fiscal consolidation.

But in fact I think a plan called for shared sacrifice across a large swath of the American public is one that would in fact have popular political support and it would be feasible to reach, so I think maybe this is just a little bit of the afterglow of an election, but I am optimistic that such a thing is at least feasible.

It would carry with it some long, very important foundational improvements for the US economy that could set us on a fairly extended period of reasonably strong growth given what I see as considerable slack in the US economy and benefits from reducing that.

Carla Hills: Dave, you may get the prize for the cheeriest note of the afternoon. Next at the microphone.

Steven Canner: Thank you. I am Steven Canner from the US Counsel for International Business. And this is a, I think, a soft easy one for Adam. You spoke a lot about Italy, Spain, Greece, but in the last week or so France's President Hollande has introduced a new element into the equation.

Could you say a few words about the challenges that he faces and if he is not successful in making France more competitive, how this affects not only the economic outlook but the political dynamics inside the European Union?

Adam Posen: It's a very—it may be a softball, it is a very curved softball. Thank you, Steve. I would encourage you to talk to my colleagues Jacob and Nicholas Honhal and Gary about this but I will put in my two cents.

I think, putting it crudely, a lot of us were waiting for when Spain and Italy worked in concert and then swung France so that that could move the agenda in various ways. Obviously by implication saying that therefore Germany would not get to set the agenda in accord with its own domestic political needs.

And there was a very memorable occasion about six months ago when Italy and Spain did successfully move the agenda in a very constructive way. Mario Monti, who has graced this stage and Prime Minister Rajoy had managed to do that.

Will Hollande be part of re-balancing in that sense? I think underlying your question is a very important point which is while the macro numbers out of France for the last few years were not terrible; there is something of the bumblebee to France's economy.

We know it flies, but we don't understand why or how. And that remains sort of the great mystery of France. And someday if somebody wants to volunteer to write a book for the institute on that, that would be nice.

But I think to project your question, I think the prime minister, I think President Hollande is going to have so much to do on the domestic front that you could argue that it will make him more willing to side in a constructive way with Italy and Spain, but I fear it means it will make you more self-absorbed and therefore be less willing to push hard in European affairs. I will be very glad to be wrong about that.

Carla Hills: I think you would all agree with me that we had a wonderful presentation. So join me in thanking Dave Stockton, Adam Posen, and Nick Lardy. And thank you all for joining us today.