Event Transcript

The Global Debt Market Effects of Federal Reserve Tapering and Euro Area Stabilization

Lucio Vinhas de Souza, Moody's Investor Service
Adam S. Posen, Peterson Institute for International Economics
Dietmar Hornung, Moody's Investor Service
Jeromin Zettelmeyer, Peterson Institute for International Economics

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Adam Posen: Ladies and gentlemen, it is my pleasure to welcome you back to the Peterson Institute for International Economics and welcome you back to Washington where nothing ever happens of any note, certainly not in the sovereign debt sphere, nothing ever happens of any note. I am Adam Posen, President of the Peterson Institute for International Economics. It is my pleasure to be welcoming you to the second of our semiannual sovereign debt panel presentations—sovereign economic panel, I should say, presentations—which we do jointly with Moody's Investor Services.

Just to be clear, this is a common effort where there is common interest substantively. We don't vet Moody's presentations and Moody's doesn't vet our presentations, but we do come together on what is the right subject, what are the right audience, and who should be speaking; and we're delighted we're doing this for a second time. We have many hundred people coming in to us by webcam, over our website. I hope also through some Moody's methods, and we are delighted to start there today. I have been partnering in this effort with Doctor Lucio Vinjas de Souza if I've gotten the pronunciation one eighth correct, who is Chief Sovereign Economist from Moody's. This is an ongoing effort.

Today we're going to be talking about two topical issues, although probably not the topical issue which is US debt shenanigans. We are going to be talking about two other important issues. We're going to be talking about the effects of quantitative easing tapering on world markets, on debt markets, how it differs across countries and take that though Lucio, and then I will speak on that and then we're going to be discussing, surprising for everyone except perhaps our colleague Jacob Kirkegaard, stabilization of conditions in the Euro Area. Moody's has just come out with a very exciting report that actually does a very nice case of taking through some of the structural reforms and their benefits in Euro Area.

And Jeromin Zettelmeyer, who's with us for a few weeks, will also speak on these issues. Jeromin is a non-resident senior fellow here at the Institute. In his other life, he is the deputy chief economist of the European bank for reconstruction and development, and is a noted economist and scholar on issues of debt crises and recovery from them. For our first, as it were, panel, it will be Lucio, myself; and since I cannot be like a Central Banker must be bound to the mast, I cannot be trusted to keep my own time. We've asked Richard Canter who is Chief Risk Officer from Moody's to Chair the first session. So, Richard, it's up to you if you want to come up or you just want to hold up signs when we start running out of time. Great.

Lucio Vinjas de Souza: Thanks so much to all of you and once again, thanks for Adam for the ongoing partnership that we have that has been, I would say, for both parts amazingly satisfying, even on a personal basis I would say. Now, what I am going to be talking to you now is effectively a report that we put out two weeks ago, talking about the real structural question that we have in terms of the US economic policy not an artificial crisis which is created by political posturing. That is real; that is a structure; that will happen. Right? The other stuff, not really. So, now just to remind, certainly not you, but ourselves why we are talking about something like tapering. The initial reason why monetary authorities are on the planet have to do "tapering" so just liquidity provision is because of that very impressive graph that you have in front of you. ZLB, of course, is the Zero Lower Bound.

What happened is that when the crisis struck, basically all major systemically important banks around the planet pushed the official interest rates here of the European Central Bank, the Federal Reserve in the US and the Bank of Japan effectively close to zero, or effectively negative in terms of adjustment for inflation. All of them, right? When a Central Bank hits the Zero Lower Bound, you cannot go down further. That's not actually true, right. As we know, you can play around with certain types of and tricks. And you actually can make the Zero Lower Bound go beyond zero. There are some Central Banks that actually do that. The most notable example that we have of that is the Central Bank of Denmark who makes markets actually pay for the privilege of parking money on them.

But that's not only unpleasant. I mean, who likes to do that, but actually, it's technically complicated. Right? So Central Banks tend to prefer to assume that Zero Lower Bound is a hard constraint. You really cannot go further than that. So you hit to the Zero Lower Bound, you run out of your traditional money policy instrument, what do you do? You play around with liquidity. And that's essentially, what Central Banks have been doing. That is the best visual representation that I can think of as the expansion of liquidity. And once again, if you take a look and see that this has been systemically across the large Central Banks, the systemically important ones on planet Earth. All of them had very significant increases of the size of their balance sheets in relation to GDP. Roughly speaking, they more than doubled.

In the United States, this has reached a level which is effectively a historical record. Last time that the US had the balance sheet which was roughly equivalent to a quarter of US GDP was during the Great Depression when, of course, the US GDP was much smaller than what we have today. But if you look at the other guys, basically the same process happened, and if you look at what this proposal should be going on in terms of Japan, those guys who keep on expanding the balance sheet of the Bank of Japan up until it reaches around 50% of the size of Japanese GDP.

Mind you, that's actually not the record among developed economies. In terms of share of balance sheet to GDP, the winner of our competition is the Central Bank of Switzerland when it is above 85% of the size of Swiss GDP. Of course, the composition of this balance sheet increases much different essentially have been buying foreign currency because of the actual GDP, so it is a different type of exposure. So we hit the zero loyal bound so we have to start with something else, what we do. We do provisional liquidity, all right.

The interesting thing is that when central banks do that, the real piece of the action, where the increase of the balance sheet is happening, is not as one might think in terms of the traditional one, which is exposure to the sovereign. As a matter of fact, when you decompose in terms of the components of the assets side of the balance sheet of the central banks, what they actually have been doing is to increase their exposure essentially through private sector agents, because of the provisions liquidity to market participants. In relative terms, the actual exposure to sovereigns from the side of the ECB and from the side of the Federal Reserve, especially in the case of the Fed, actually decreases.

In absolute terms, of course, it's larger now because of the increase in terms of the size of the balance sheet but in relative terms, the real piece of action is the provision of emergence liquidity effectively to private sector agents. Okay. So they did that but now we are talking about tapering. So why we're talking about that? Essentially, because of that, that's the underlying cyclical reason for the discussion.

For the sharp minded among you, you realize that contrary to Japan, contrary to the Euro Area, the US never had a double deep recession. The United States -- land of the brave, home of the free -- returned to relatively robust growth already three years ago. In practical terms, you have an average growth rate since 2010 above 2% which, believe me, is in terms of development is rather respectable. More than that, if we look in terms of the medium term projections, the United States is expected to keep on growing by almost 2% points every single year faster than both Japan and Euro Area. We don't really assume that there is a change in terms of the trend [inaudible 00:08:59] this is open for discussion but that’s our assumption.

So in practical terms, the cyclical reason why the United States had to do what it did in terms of monetary policy and monetary policy actions that were unusual, essentially is not really there anymore, right? So that's the underlying reason why we are talking about tapering now. The cyclical situation in the United States is fundamentally different than when they started pursuing this course. Okay.

So now, the implications of tapering, yeah, in other terms the progressive reduction of this increase at additional provisional liquidity to private sector agency is the following: essentially, the way that this is received is that this creates a potential for destabilizing capital outflows out of the recipients of the great [inaudible 00:09:58] of money. How did this pan out?

You created this very large amount of liquidity on the central economies on planet Earth, the large developed ones. Effectively this implies that not only do you have this very large amount of money but you have searched for [inaudible 00:10:11], right? You have someone that has this large liquidity to invest somewhere where you're going to have more returns than what you have in places like US. So you have these capital inflows into those economies, right.

When you start tapering, the reverse should start happening. That's the mechanism through which tapering would affect economies around the planet -- is the potential from capital outflow because the differential in terms of yield it starts to disappear. Now, one underlying assumption of this, especially if you look at some media commentary, is that the guys are going to be hit for that are essentially the developing nations. You're going to see on the analysis that is going to presented in the moment that's not actually true when we look in terms of our simulations. There is one particular guy among the developed countries in the universe, which is actually significantly, hit by the [inaudible 00:11:08] at least in our estimation. All right?

Now, we have already observed some reactions in terms of this announcement of policy. Remember, nothing of this has happened yet. But what happened is just a boldest statement, a verbal intervention from a Central Bank, nothing has been done and you already have observed significant adjustment for instance in terms of the nominal exchange rates of a series of a large recipients of capital inflows, as you can see in this sample of developing economies in front of you.

Okay. So how are we going to try to estimate the effects of tapering? Basically, we're going to be doing the following: We're going to implement in terms of a state of the art computable general equilibrium, a series of scenarios in which we project to the Fed to be increasing its interest rate effective that's what we do in terms of our scenario playing around. Because the speed of the adjustment, how fast the Fed will bring the interest rate up is unknown, we do that via a series of scenarios. Visually, they look like that.
Essentially, what we are doing here is to estimate a "height scenario." You can think of this in terms of the assumption that markets truly are rational, right, and forward looking. You know that the Fed will eventually have to increase interests. Because you know that, what you do as a forward-looking market participant, is that you immediately bring the interest to the desired long-term level of the Fed. That's what we call the "height scenario." Think of this as Fed starting tapering now and it stays like that until the median term.

The second scenario that we estimate there in one in which the speed of this adjustment, the tightening of the Fed effectively emulates the time frame of the less tightening episode that we have of the Federal reserve, the one that was pursued in 2004. And the last scenario is one in which we have a slower profile of adjustment from the Federal Reserve effectively one that will last us until 2016. And we estimate the differences in terms of GDP growth and another series of variables between our benchmark which effectively is a much smaller and much slower adjustment of those three different scenarios. Now, what happens when we do that?

I will present this visually to you here because figures are always nicer than words. What you are seeing here is the following: albeit to the assumption that developing countries are hit, in absolute terms, more than developed countries is absolutely correct. You can think of this in the following terms, the cumulative GDP loss for our developing countries universe between now and 2016 is roughly 3% points, right? While the one for the developed economies is say, 1.5 … roughly half of that. So the size of the hit in absolute terms is larger but not in relative terms.

Effectively what this is showing to you because the trend growth rate of the developed economies is much smaller than developing ones is that if I were to quantify this in terms of growth loss, developed economies lose about 1 year of growth because their trend growth rate actually is quite low; it's around 2%. Developing countries, because they have a much higher trend growth rate, they, in relative terms, are actually hit much less. Say, if developed economies, they lose about 20 year of growth, the aggregate of developing economies lose about 6 months. That relative size of the hit actually is greater for developed economies. And this essentially happens because of one country, right? That is just in America part of what I told you.

The guide that's essentially, to a significant degree, driving the results of the losses for developed countries is Japan. Why does this happen? You remember the picture that I showed to you earlier of the increase of the balance sheet of the Central Bank of Japan. The implication of that, from the point of view of the Japanese economy, is the following: you have an increase in inflation of the Japanese economy which prevents the full adjustment of the yen. So they have a significant competitiveness loss which feeds through into a significant loss in growth for Japan; this is compounded by capital outflows. Thanks for that Richard. I'll be very fast now. That is the underlying reason why Japan is hit so strongly and why the universe of developed economies is actually significantly hit is because of the stated economic policy of the Japanese government. And, of course, we believe in the statements, right? We always believe in what governments tell us.

Now, in relative terms, when we look at the developing regions, the outcomes are somewhat more intuitive. One would expect Latin America, which has significant degree of financial integration to the United States and therefore has been one of the greatest recipients of this wall of money, to be the most strongly hit in terms of developing economies. And that is what is estimated in our exercise. Not only that; if you take a look at those two different projections; the one on the top is for [inaudible 00:16:51]. The one here is for developing Asia. Not only the hit for Latin America is significantly stronger; it lasts much longer, right? Effectively, by 2016, if we are looking at the universe of Asian developing economies, basically have been brought back to trend, right? That is still not the case in Latin America. So the hit is harder and remain there for longer.

Now, this is essentially just an expansion of what I just told you in terms of the relative losses that you have in terms of GDP. We do other estimations we share on the paper that you have. On the back, it usually looks to the effects of for instance, current account balance and what you have there is the outcome is a very economic one, so it depends. Right? Essentially, if your account that has, for instance, a flexible exchange rate, you can have beneficial effects in terms of your current account position even if you are hit negatively in GDP terms.

Now, two things that I should put in terms of what you have seen. It might have looked impressive in terms of the hits that I showed to you but when you look in the relative terms, effectively this is a relatively small effect and is always temporary. Because essentially, what we are talking about here is a sort of adjustment back to what should be the long-term value of those variables in any case. So this is just a transition cost when you are going back to the "normal." So it's relatively small and it's always temporary. This is conditional. This is an estimation. Why? Because countries have tools to react, right? If you know that there is incoming train going in your direction, you can do many things. One of them, jumping out of the tracks. Right?

Countries that have policy tools and that have buffers, they can, in one way, counteract the effects of those estimated efforts, and you have seen exactly that. If you look at countries that have, for instance, floating exchange rates, that have large amounts of hard currency reserves, which incidentally is a good description of what is the developing universe nowadays. Developing countries since the 1980s have become essentially floaters by and large, and have accumulated large amounts of hard currency reserves. They have policy tools to cushion the shock, and what they have done so far. Exactly that. They have used the policy tools to attempt to cushion the shock.

So regardless of the relatively impressiveness of the [inaudible 00:19:37] that I showed to you, we should always remember, the loss is temporary, they are relatively limited, and they're estimated ones because countries can do things to cushion the shocks; that's the link to the paper that you have in your folders. And I look forward to your reactions to our presentation. I think that now we have you back. Thanks so much for that.

Adam Posen: Thank you, Lucio. I am PowerPoint free today, so I don't have the pretty pictures. You may see me wave my hands a little to go with that. Let me give you a slightly alternative take on tapering, and I think I come out actually in much the same place as the simulations that MIS did in these papers. But I want to give you a bit more of sort of the Central Bank perspective, the monetary policy perspective on it, particularly in light of our new incoming Fed Chairman and our surprise in September for at least was surprise for many people.

Now Lucio says, and many people say, at some point you have to raise rates, and that is of course true. Unless you become Japan and the economy never gets back to normal, but now that the Bank of Japan is actually doing quantitative easing in a meaningful way, I am hopeful that that will cease in Japan. I think it is important to recognize a couple truths though, just a couple operational details that matter. The first is that when Lucio puts up the bar charts with the stacked bars that—see my great hand motions—about the share of where things go.

He understandably doesn't break down treasuries or government bonds in different categories, but it is critically important that in Japan, for years, since they were expanding their balance sheet. They were buying very short terms government bonds. They were buying government bonds three years or less, totally mostly two years or less. And as Kazuo Ueda and Bob McCauley published at the BIS, when you document this with [inaudible 00:21:53] it shows you why quantitative easing had very little impact in Japan.

Because if you believe as most of us do—who believe in quantitative easing, which is a separate matter—that the main way it happens is through influencing people's portfolios, taking long terms investors and trying to shove them out the yield curve in to other assets. It matters a great deal, whether you're buying cash or whether you're buying assets that actually induce substitution.

So I think it is an important piece, not necessarily for the longer run projections that we had here, but it is an important piece of the story to pay attention to what they buy. And that is going to be part of the taper story in any country because it depends how much you are willing to sell off in a given market, how big an intervention you are to have. In particular, while I was at the Bank of England on the monetary policy committee, we had a lot of internal debates on whether we should be buying something other than guilt. And I was pushing very hard for much my time there for us buying other things, preferably securitized bundles of small business loans and such.

Now leaving aside my own particular hobbyhorse, what was important about the debate, in a sense, was the way it was conducted. So there were sort of two levels on which the debate was conducted. One level of the debate was all that matters is the size of the balance sheet. It actually doesn't matter that much what you bought—actually, there were three levels—this middle level was, well, there are certain things we might want to buy but operationally it's very difficult.

So for example, in the United Kingdom, the corporate bond market, despite Moody's and others best efforts is very very thin for domestic corporates. And if the bank of England had gone in on any scale, we would have essentially bought up the entire corporate bond market. And for operational reasons, that seemed like a bad idea as even I was willing to admit.

And then, so to the third level of the tapering discussion or, excuse me not the tapering, the QE discussion was Central Bank independent's question. And that was present in the UK but not front and center the way it became in the US. In the US, with Congress, which as we can see exercises good judgment at all times, with Congress, there was a repeated concern that if the Federal reserve was buying things other than treasuries, it was getting into fiscal policy. It was getting into allocative choices between different interests in society and therefore this was to be frowned upon.

Ironically, if you go to the other side of the Atlantic to the ECB, rather than the bank of England, which Lucio correctly, by implication, shows is not a systemic Central Bank. If you go to the ECB, they made the exact opposite choice which was it's much better to be buying bundles of privately placed papers from the French banks that to be buying government bonds because when we buy government bonds, were bailing out the sovereigns. It's just an interesting thing to note in this context in what we take about interventions of governments into markets that the political context can completely change even amongst supposedly similar Central Banks who, as Lucio points out, are reacting to similar challenges.

So what does this have to do with tapering? And then I'll get to the international aspects. So as we unwind, as Central Banks—I should stop using we, I'm here now and I'm definitely not a candidate for any Federal Reserve offices—as we unwind these positions, how should you think about it? And so one point has been thought about in great detail is this question if when you move interest rates versus when you move your asset purchases. And interestingly, the Federal Reserve and the Bank of England have gone in completely opposite directions.

So a couple of years ago while I was at the bank, we made a statement ahead of time—more ahead of time than we would have liked—"When that glorious day comes that the economy recovers and we will have to tighten. The first thing that we will do is raise interests rates. And we will raise interest rates as high as we have to and then at some point when we know that economy is back in normal times, we will sell off the accumulated extra assets over several months with a very long term plan."

In the Federal Reserve case, it has gone the opposite way. It's been made clear that we're going to taper purchases and if necessary, we'll start selling off assets, before we start raising rates. Again, it's a subtlety but it will have some effect in the way the markets digest these things and it's worth keeping in mind. I think moving on to the more and broad macro picture, the key thing to be understood is: as confused as markets and most of us observers have been by the Federal Reserve, the Federal Reserve has been stupefied by the response of markets to its behavior.

Let me try to explain, as I've tried to explain this to Federal Reserve officials, what I think has really happened. So, Ben Bernanke, our outgoing Chairman deserved of much praise and thanks from all of us, gave his press conference in May and was seen as saying, "taperings are coming." As a very few smart people pointed out at the time, if you listen to him, it was actually sounded the opposite. It was, "Here are the following 17 hurdles we'll have to get through before we're going to think about tapering;" that was, in a sense, some people interpreted as a very dovish statement.

Then of course, we had all the subsequent recasting that made the markets convinced that it wasn't going to be that way. But I think what was really the disconnect between the Fed and the markets was, the Fed was so focused on this forward guidance notion and the idea that if we the Fed were to explain our reaction function, everyone will be calm and they'll understand. Moreover, we're going to get an extra instrument because we're going to commit to keeping interest rates lower for longer and if we explain it right, people will understand that and we'll have great effects because of this.

If I'm sitting there at a hedge fund—God forbid—if I'm sitting there at a hedge fund trading treasury securities, at any given moment, I think there are some distribution of possible Fed actions. They say they're going to taper; I immediately chop off this tail of the distribution of the possible Fed actions. They're not going to do any more expansions for the foreseeable future. So I now have a distribution that looks like this. The mean and the mode and the moment of that distribution all shift towards tightening.

And that's exactly what happened, and the markets rightly perceived the ruling out of loosening as effectively a tightening because you couldn't believe the cheap talk they were saying. For whatever reason, this is the way many hedge fund and many investors and fixed income investors talk about, the Fed couldn't understand this and to this day resist this.

So what does this means going forward from here? What have been the effects of tapering on the globe and particularly on the emerging markets over developing economies that Lucio points out? I think there are a few things that are worth noting. The first is—and I'm by no means the only one to note this—it is a very big lesson for all of us that exchange rate movements cannot completely insulate you from what's going on abroad.

That was sort of the founding myth of the flexible exchange rate system; it's been debated many times including in this building. But just to give you the extreme example, we're sitting there at the ECB, sitting there at the Bank of England, you've suddenly seen your long bond interest rates go up, you have given no indication of tapering whatsoever—look at the chart Lucio put up—you're not going to taper for a while yet. And yet, you've seen a tightening in your money markets. Why is that?

Because the Fed's tightening. Well, shouldn't, according to uncovered interest parity or something good like that, your currency go down to compensate for the fact that everybody knows you're not tightening? No. It hasn't happened. And this has been sustained now for going on almost six months. So there is something fundamental there that we're not grasping and that even the largest most independent monetary economies are still being driven by Fed action, which is very interesting. It's surprising.

The second thing which, I think, either us or Moody's Investor Services or maybe us jointly should look at is, in real economic terms, it seems the first order effects on growth this time through, on say Latin America, of a Fed tightening are not that different. Or in anything, might be smaller than the effects on growth of previous tightening cycles by the Fed. So Lucio goes … but if you listen to the rhetoric of--oh I don't know, say Brazil, the wall of money coming out quantitative easing was uniquely disruptive and destructive in a way that simply the movements of Fed mandatory policy in the past were known.

But you look at the magnitudes of the kinds of things Lucio is putting up there, this is no different than the old stories of US sneezes, Latin America gets a cold that those of us who lived through the 80s or 90s are well familiar with. And if you go on further and you look at—picking up on something Lucio said which I very much agree with—if you look at the extent to which structural factors and some policy options in a number of these emerging markets affected the transmission, that influence of QE and tapering is smaller still.

So if you look at and make the comparison of how Mexico has responded, for example, to the Fed shock versus how Brazil has responded—and when I say respond, I mean the economic response, I don't mean the policy response—but it's conditional on the kinds of mandatory policy and structural reforms that we've done beforehand. Now again, that sounds very simple and should be obvious but it is not something that keeps coming up, it's about the taper is this global wave. So let me leave you with two main points.

First, I strongly encourage you to go back and look at the presentations last week here by my colleagues Arvind Subramanian and Nicholas Lardy at our semi-annual outlook meeting. We do two semi-annual things. We do this with Moody's and we do, the week before, we do our semi-annual outlook. Arvind makes an extremely compelling case for the fact that emerging market growth in recent years was not driven by loose money, and that the vast majority of emerging markets after this initial run are not going to be affected by what the Fed is doing. That India in a sense made its own bed. And Nick Lardy makes a very compelling case, among other points, that China, of course again it sounds obvious but it's worth noting, has not been directly impacted in any meaningful way by Fed tapering.

So when you put all these together, we still have this funny thing to think about why in the UK and in the Euro Area, long term rates are going up and the currency's essentially flat against the dollar. But making a big statement that emerging markets have somehow been overwhelmed by Fed tapering beyond the initial shock, I think is very misguided; not a good ground for investment or for assessing sovereign risk. Thank you very much.

Adam Posen: The idea is we're now opening up for questions and discussion. We'll do that for roughly 10 to 15 minutes, take a brief networking break, and then move on to the second panel. We have a travelling mic up front and a standing mic at back, if anyone would like to pitch in and of course, your words will also go out live over our website which is part of the reason we want you to use the mic. So please anybody? My defense of QE didn't bother anybody? I'm shocked. Oh please. If you can give the mic to that gentleman?

Gentleman 1: I have two questions. First, about the Fed's communication program. Many experts in the meetings of the IMF and the World Bank, and I know meetings there are communication problem with the Fed's [inaudible 00:35:01] talk and make the markets confused so can you elaborate more about this? The second question is given the fiscal battle in the Congress do you expect the Fed, is the idea possible to taper this year or maybe next year? If by the end of this year, there is no taper, will this put the Fed credibility into question? Thanks.

Adam Posen: I mean, I'm happy, but you may want to come in a bit on at least the US budget situation.

Lucio Vinhas De Souza: Okay. So let me try to take your second question if I may. I start by something that Adam actually said which is the amazement of the monetary authority concerning the reaction of markets. And as a former policymaker myself, I also sympathize with this position on the sense that you are a policymaker here right? You're trying to do your best not to try to spook markets.

On the previous lessons of the previous tightening episodes of the Fed, markets tend to remember the so-called Bad Exit of 1994 in terms of tightening episodes of the Fed. As you are aware, what they did after that—namely Alan Greenspan who was responsible for the tightening of 1994 and 2004—was to create a communication policy from monetary policy decisions that was designed to try to make sure that market participants kind of got what monetary policy was all about. Right? And on my reading of the actual statements of member [inaudible 00:36:48] I mean the guy was effectively sticking to script in terms of what he was supposed to do. Right?

The Fed has been quite transparent in terms of what the triggers are for the tightening part of its monetary policy, not to the withdrawal of liquidity, this is a more qualitative call for them, but in terms of the actual America [inaudible 00:37:19] has been extremely transparent. Right? Given that this is out there—that markets have been informed of that and at the same time, the Fed has been making very clear that economic conditions and particularly the fiscal situation in the United States would affect the timing of tapering. I would not expect this to be anything more in terms of the actual beginning of the process of tapering than a delay of a few months.

If I were looking in terms of a timing for the actual beginning of [inaudible 00:37:57] sections, I would not have interpreted that as being more than a delay of few months. Now, being that [inaudible 00:38:06] to the fiscal situation of the United States, but just going back to this freedom of maneuver of the Federal Reserve. Imagine what we would have had in terms of market reactions if you had shutdown, if you have discussions about capping of the capacity of the United States to actually show that and you had actual tapering going on at the same time that all of this was happening.

The Fed clearly made a statement a few weeks ago on the last meeting of the FYMC, in which they're signaling already that they were not going to engage in [inaudible 00:38:43]. One of the reasons for this being the fiscal situation of the United States. Now, on the specific situation, I will be very brief here to give you time on that. The position that we have been conveying concerning the fiscal situations of the United States can be summarized in the following: shutdown is not a significant worry from our point of view.

The real question that brought concerns to the table is effect of the non-raising of the debt limit in the United States. The timeframe for this is not what has been necessarily been conveyed by the Department of Treasury. The US has a considerably different fiscal position than when you had the last shutdown. The amount of need for issuance into covering the needs of the United States now is considerably smaller than when you had this for the last time, when you had the shutdown two years ago that was roughly 40% of your expenditures that needed to be covered by essential insurance. This is more than half and now it's only about 20%.

So the fiscal needs of the United States in terms of insurance are much smaller. There are tools that the fiscal authorities in the United States can effectively use to give it a much considerably time margin of maneuver. If anything, the next upcoming significant payment for the US government is not going to be appearing before the second half of next month, so the time frame for discussions is much larger than that and there are policy tools related to this. All right? So just summarizing our position. Real problem would not have been shut down, would have been the no raising of the insurance of debt for the United States.

But even here, when you look in terms of the availability of instruments for the US treasury and the actual need for insurance in the United States, the shortest considerably smaller thing would have been, say, two years ago. Sorry.

Adam Posen: No. Not at all. I know people were very eager to hear you speak on that. I'll just say quickly on the US situation, Dave Stockton also gave his semi-annual US outlook here last week, it's available on the website, and he also makes the very strong distinction between shutdown and debt ceiling. But I think he, and certainly I, are a little more concerned that the immediate macroeconomic impact if you have a debt ceiling binding would be quite large. Because if you're talking about 20% of government expenditures and you prioritize interest payments, you're taking out a whole bunch of very high multiplier things at a basically an annualized rate of 4% of GDP. Now if that goes on for a couple of days. All right. If that goes on for a couple of weeks, you start talking with very real numbers.

Second thing would just to say that a number of us are emphasizing is—and this is obviously not Moody's remit to worry about but it’s definitely Peterson Institute’s remit to worry about—is what this will do to US international standing and ability to speak in international fora. I mean, just this week, at the IMF World Bank meetings, we're seeing that whatever other agenda people want, it's getting crowded out by people yelling at the US delegation, which frankly is entirely legitimate because this is now the single greatest threat to the world economic recovery.

But in other sense, it means you're not doing anything useful because yelling at the Undersecretary of the Treasury has no influence on the people in Congress and there are other problems that remain to be worked in the world. And then we think about going further into the trade negotiations and ongoing--US being put in this position by its own actions is very destructive.

Just quickly, your question was really about the Fed, I very much agree with most of what Lucio said. I would just say, I think it's a mistake to talk about the credibility of the Fed being at risk by do they or don't they taper by a certain point, because what really matters is, do they have a credible commitment to price stability over the medium term. And so if they were to do it by, “Well we’ve talked about tapering, we haven't tapered yet and therefore we have to man up as it we were,”—to use an inappropriate expression—“and taper whether or not we want to, that would be insane.”

And that essentially, a light version of that is what was in the minutes in September that, “Well, you know, the fiscal situation is going to hell, and the sequester took more out of the economy than we expected, and the market's kept in more tightening than we expected. And therefore, even if we thought it was time to taper two months ago, it's not time to taper now.” And I think that that's fine but when you get into communications trouble, is when instead of talking about things perfectly sensibly in terms of the forecast, you start talking about it in terms of this very fine tuned language of forward guidance. I think you're just asking for trouble.

This is my own particular thing but at the Jackson Conference last summer, I made a very strong, not very effective obviously, statement that forward guidance was going to just end in tears. And we spent 30 years saying Central Bankers are engaged in cheap talk. Why is it suddenly, we not only think talk isn't cheap but your talk can be finely calibrated and fine-tuned and markets are going to get it. It made no sense to me and I think it still doesn't make any sense. Any other questions or comments. Let's go to the … gentleman over there and then to Jeromin. If you could just identify yourself before asking a question please.

Jod Darelshcrum: Yeah. Thank you. My name is Jod Darelshcrum from Bruegel. I have a question on … to Lucio on the impact of QE exit on Japan as you find that Japan would suffer the largest impact among developed countries. I'm a bit puzzled by this result. If I understand well, also what's in the slide is that continued a QE in Japan would lead to inflation. That would have an impact on the [inaudible 00:45:28] that in turn would lead to kind of competitiveness lost and bigger current account surplus and ultimately a GDP contraction.

Now, first of all, I don't know what kind of exchange model you have in the CG model [inaudible 00:45:45] but if you have a kind of PPP model then higher inflation need not necessarily lead to a real exchange adjustment. But more fundamentally, I think you need to have a very strong impact of inflation on the real exchange rate and then in turn a strong impact from the exchange rate to current account and output which, I mean, if you could elaborate a bit more it would be helpful. Also let me just note that I mean, in Japan you're talking about you know inflation of 2% instead of 1% so in the next three years, there could be a cumulative excess inflation of about 3%. Now, exchange rate used to fluctuate much much more. So I'm a bit puzzled by this result.

Adam Posen: Thank you

Lucio Vinhas de Souza: I will not necessarily enter into the parameterization of the model to greater detail but essentially, we get the results that we get because we derive long-term elasticities of our relationships concerning the Japanese economy, right? You can assume that if you use a different timeframe for your parameterization, the results should have been different but then again, you should not start playing around with models just because they give you results that you don't like.

We try to be as consistent as we can in terms of the individual countries that we have in our modeling framework so that we don't put ourselves in a situation in which we start fishing for results of the data. As concern in the particular results for Japan, one thing that we did try to reflect—and that is something that I personally think drives the results on the data—is to imbue the stated intentions of the Japanese monetary authority between now and 2015. Namely this very large increase on the balance sheet of the Japanese Central Bank and the past [inaudible 00:47:46] that you have in terms of inflation.

That was likely the only account in the model in which we imbued this particular reaction function of the monetary authority simply because we have the stated intention of the Central Bank of Japan. If we essentially had a similar reaction function from what we had through other Central Banks like the results would have been much more muted.

Adam Posen: Very interesting. Jeromin, I think, is next. The mic rod's coming to you.

Jeromin Zettelmeyer: Yeah. I just wanted you to maybe elaborate just a little bit more on the abuses and uses of forward guidance. So what seems pretty obvious, you know, from everything that has happened and just from the general logic is that it's a very bad idea to use forward guidance to accelerate a turning point in monetary policy. It's a bit like announcing that you're going to devalue nine months from now. Right? You're going to get the run right away.

Lucio Vinhas De Souza: Right.

Jeromin Zettelmeyer: And now, does that mean it's always bad? So, for example, in the UK as you well know, Mark Carney has been trying to, in some sense, fight the implications of forward guidance in the US by having some forward guidance of his own with respect to the Bank of England. It hasn't worked very well. Is your point really just: "look this is stupid because it's … at best it does nothing, because it's cheap talk, at worst, it can essentially add volatility?" Or are there some circumstances where forward guidance is a sensible thing?

Adam Posen: I'm an extreme outlier on this in the community, but essentially, I'm your option A. Or option B, I don't know, I guess it's option A. It's essentially stupid because it either does nothing or it does harm. Let me try to expound on that just briefly. As Lucio just said, we're used to thinking in terms of reaction functions in Central Banks. Reaction functions in Central Banks are very reduced form; they don't really capture everything you care about especially as Central Banks get to Zero Lower Bound so it's not easy to model a simple rule, as you start having financial stability concerns, as you worry about asymmetry, as you worry about policy. There are a lot of problems with reaction functions in Central Banks.

Nonetheless, essentially, that is not only the way that most markets people and most academics think about Central Banks. That is, in my experience not just in Bank of England but in … elsewhere, largely the way Central Bank policymaking communities think themselves. Mervyn King used to get very upset at times with us at the MPC because we would spend all these time talking about the real economy and trying to make forecasts of the real economy and he's like, "We're a monetary committee. Why are we spending all this time talking about this?" But you go back to the Federal Reserve minutes and you find the same thing. ECB's a little less transparent but still you will find much the same thing.

So where does the communication of forward guidance kick in? So to me, what makes it forward guidance is you're trying to impart information that isn't in the disclosure of what your target is because that's already out there basically and it isn't about what your reaction function is; it's that you want to do something above and beyond the reaction function. So that could be, "I'm taking bubbles seriously," or, as I think a lot of people at the Fed intended. And certainly Incoming Chair Yellen would say, "I want to make sure markets know I'm going to keep rates lower for longer to try to make up some of these past gap since I can't get rates down as low as I would've wanted to."

This is the Michael Woodferd-Gauti Eggertsson forward commitment kind of thing. And to me, I find that just not very credible because we have built in for good reason, this expectations as Central Banks react to the forecast of either GDP or unemployment and inflation. If you're busy telling people that my main new piece of information for you is, "I'm not going to respond to that in the way you think," how are they going to react? And now, it is conceivable that over some very lengthy period of time, you can convince markets how to deal with this but by the time you've done that, you may be back in the normal economic world and it's not clear this does you very much good.

So I had a lengthy debate about two weeks ago with my friend Lars Svenson the former Riksbank Governor who believes wholeheartedly in this stuff and tried to get the Swedish Riksbank to publish all these inflation for interest forecast for individual members and try to ever be more transparent. I was saying to him, "Lars, you just spend X number of years inside the Central Bank making decisions. Don't you believe there's some point those are diminishing returns that you're confusing people." "Oh no no no, I can show you on my laptop. Every time we said something, it moved the right way." "What are you talking about? In 2011, you said X and the market you were trying to loosen and the markets pushed up the interest rates? "Oh yeah, yeah, yeah, but…”

Anyway, I hate to say this but I think it's a bunch of academic economists going down the rabbit hole again. And we had academic economists go down the rabbit hole with respect to a lot of things in macroeconomics over the last 20 years and I think this is another one. I think we should take a brief break, coffee. Do you want to take a break or do you want to not take a break?

Richard Canter: I think there was a last question.

Adam Posen: Oh, if there is a last question, please proceed to the microphone so we can do that.

Richard Canter: It was Jacob as far as I can remember. And then we can take a break. Just to be fair to your side of the table.

Jacob Kirkegaard: Just very briefly, if I could push you a little bit. You seem to say that you think that the current fiscal morass is only going to be a few months of potential delay for the tapering. Does that imply that you expect the fiscal morass to go away in just a few months? I mean right now, we seem to be heading for this wonderful credible policy of doing fiscal policy for maybe 6 weeks. I guess another way to put it is: Is there a minimum threshold for a longer-term fiscal decision, a fiscal policy making decision in the US Congress that needs to be met before it would be sensible for the monetary authorities to change their tapering policy?

Adam Posen: Let me give a view and then Lucio can have the last word.

Lucio Vinhas de Souza: We need to elaborate on the economic concept of fiscal morass.

Adam Posen: Yeah exactly First Jacob, let's think about what we think is actually going to happen. My best bet at the moment is that we get to October 16th, 17th and we have another tarp moment, so the Federal reserve chair still Ben Bernanke and the Treasury Secretary, presumably still Jack Lew get there, get down on their knees and basically say, "This is going to be really, really bad. Don't listen to what this particular Congressman is telling you. This is going to be really, really bad. Please don't do this." and I hope—

and I put in a slightly better 50% chance—that several congressmen of the Republicans who are not entirely tea party crossover and you get a vote for a clean resolution.

The alternative is one of two things. The republican say well, "We'll do this but only for six weeks." I think you're wrong about that Jacob. I think the president will not accept that. I think the President will just say, "That's not an acceptable option. We're just not going to do that." Now, different opinions are out there but I really don't see any way in which the White House, given their characterization of the situation, sort of hostage taking, can agree to that. So then you get the real tarp scenario which is Congress lets the debt ceiling bind, markets crater for a couple days and then God willing, they come running back with their tail between their legs and they pass a good resolution. And you and maybe Fred would probably enjoy this because it would be like the Berlusconi good old days of the ECB, right? That we've forced a crisis and induced better behavior.

I'm not saying I endorse this but I think that this is to me is where we're ending up. So from the Federal Reserve's point of view—I mean, I don't know—but my presumption would be, you've got to distinguish between two things. If it's just a question of ongoing uncertainty that the Congress is a bunch of yods, or whatever the appropriate expression is. Then what you do is you basically say, "I'm expecting there would be an ongoing damper on investment," and figure that into my forecast and that doesn't rule out that at some point, I'm going to be tapering, but it probably pushes back the date of taper.

If it's, really, you're going to see fiscal contraction, then something different and again just for the record, Dave Stockton said something very similar last week. I think it's reasonable to expect that the Fed would do emergence if we had the real debt ceiling binding sudden cutback in government expenditure. The Fed would do whatever leaning against financial market panic it could and provide temporary liquidity but it would not attempt to offset the macro impact of this because it's just too large.

Lucio Vinhas de Souza: I would start exactly where you finished. If we do assume there is no increase in debt ceiling, it becomes binding and is there for the medium term, you can very easily generate really scary macroeconomic scenarios for the United States. And I do mean significant contractions when you have real losses. I have, as a default as an economist that people in economic [inaudible 00:58:48] in general, do try to prevent unnecessary harm for each other, given my strong belief on personal and national self-interest, not to mention my experience as a European during the Euro Area crisis, right.

The notion of you get to the abyss but you really don't jump it because hey, right. My take would be that given the alternative, the really scary losses that you have in anything that would be a really prolonged non-extension of the debt ceiling, that pretty soon you're going to have some sort of an agreement. And the second part of your statement, when you try to impute monetary policy reactions functions to that, the shock is simply too large, really, simply too large for monetary policy even with a very significant increase of liquidity to accommodate it.

Adam Posen: Yeah. Remember, even doves like me admit that the Fed’s kind of stretched at this point, so. Anyway, thank you all very much for your attention. Thanks to Lucio. Let's take a 5 to 10 minute break. No more than ten and come back for the very good discussion about Europe that we have coming up.

Adam Posen: Ladies and gentlemen, if I could ask you to come back in. We're going to move from US miseries to European wonders. It's all good. Breaking news update: it appears I’m already been invalidated. It looks like the White House is moving towards accepting the six-week deal. We can all contemplate whether that fixes anything or not. I think not, but that's okay. So ladies and gentlemen, it's my pleasure to welcome you back for the second panel of our semi-annual sovereign economic panel joint between Moody's Investor Services and Peterson Institute for International Economics.

We're going to be focusing on structural improvement and debt sustainability in the Euro Area. As I mentioned earlier, Dietmar Hornung for Moody's has done a very interesting and, I think, tightly argued new study suggesting that people are not fully appreciating structural reform in Europe. Dietmar is based in Frankfurt and oversees a lot of the sovereign risk economics for the Euro area from there for Moody's. While that’ll be followed by our non-resident fellow Jeromin Zettelmeyer who has done some very interesting recent work on debt restructuring in Europe and we'll have his own views on how this goes. But first, Dietmar.

Dietmar Hornung: Thank you, Adam. I’m very happy that I'm here speaking about Europe. We're not prepared to call the European debt crisis over at this stage, but it's certainly to be acknowledged that there is structural progress in Europe and that there is ongoing support but our view is that given the fragility of the situation, there are significant event. My presentation is basically four parts. The first part is on fundamental progress, and that we see the second part is on the role of backstop facilities, both fiscal and monetary in nature. Then I will highlight the fundamental challenges that remain and then in the end, our baseline scenario and also our ratings are positioned to a continued and eventually successful model through in the Euro Area.

Let me start with the fundamental progress over the past three to four years here, and the progress has two pillars basically. The first pillar is the macroeconomic progress. The second pillar is the fiscal progress and particularly the macroeconomic progress is crucial here because, in my understanding, the origins of this crisis in Europe are of macroeconomic nature and developments most clearly in Ireland and Spain, for instance, translated and ended up on the government's balance sheet. The bubble induced contingent liabilities that crystallized on the balance sheets of governments, so in that regard, current account balances have corrected.

That's the left chart here where you see that particularly the crisis countries Greece, Portugal, Ireland and Spain to a less extent Italy, have very significantly adjusted their deficits here at the order of in the double digit territory which is very impressive. Now, you can also see than within the Euro Area, the trade balance of the powerful countries relative to Germany, this trade balance has improved as can be seen from the right hand chart here. Progress is ongoing and it's also important to look at the sources of the adjustment here and if you look here at one country after the other, you will see that probably particularly Greece, it's a story of import implosion there. For basically all the other countries, there's a significant increase in the exports and that's encouraging for sure.

Ireland is a prime example here but even countries for which you're not necessarily thinking in that direction, Spain, but also Portugal, you're probably aware that particularly in the second quarter of this year, Portugal made a big step forward in terms of economic activity normalization and that was basically driven by net exports there. So on the right-hand chart; it's really net trade that drives the adjustments in the current account.

And what's behind this improvement in the current accounts in Europe, it's an improvement in competitiveness in most countries, measured by unit labor costs in the left-hand chart where you can see that Ireland has adjusted earlier than the other countries. Spain and Portugal move almost in parallel here. Germany adjusted earlier so now it's not really an issue that the wages have increased here. Some people would even argue that's part of the rebalancing in Europe. Then you have the case of Italy which is a specific case, to some extent a record in the Euro Area [inaudible 1:06:20].

And that can also be seen from the right-hand chart where you see that most countries are above their 2007 level in terms of real exports. Italy is not yet, but important, there are improvements in competitiveness which explain the rebalancing on the current accounts in a way to rebalancing on the current accounts side is precondition then for economic activity increasing given that domestic demand remains subdued in the powerful countries for the foreseeable future.

So that's pillar one, macroeconomic adjustment. Pillar two to is the fiscal adjustment here and if we look at the budget balances, I think it's really impressive what has been achieved in the periphery as a whole. On the left-hand side, you can see that when this global crisis turned into a European crisis, then in 2010, the budget balance, budget deficit of these countries was in the double digit region, and since then we've seen quite an impressive fiscal adjustment which bodes well for the future soundness of the situation of public finances.

And again, I think it’s worthwhile to take a look in what's really driving these adjustments. Here, country specifics come to the forefront starting from left to right. France, the adjustment was not as big as in other countries and predominantly driven by revenue increases in Germany, expenditure cuts in Netherlands and Austria to some extent balanced. And then you have Greece where the adjustment is the biggest amongst all Euro Area countries and significant expenditure cuts in Greece have been achieved. Then you have Ireland where the adjustment was done predominantly on the expenditure side, even so it's a country with a relatively small government so it's astonishing to some extent here. You have Portugal where more on the revenue side was done, and Spain here is a country where it's quite balanced even more on the expenditure side.

The next slide then looks even deeper into the structure of expenditure adjustments in the left chart here, and as you would expect, there is a crisis; you need to adjust fiscally. What is done the most easily is you cut capital expenditures which is not necessarily good for domestic demand and potential growth going forward, but that is something that you can see in basically all countries here. On the revenue side, particularly interesting here to look at Ireland where you can clearly see that these other revenues, these were taxes that were related to financial transactions and stem QTs, so here the implosion of the bubble in the real estate sector and the financial sector led to a significant problem.

I mean, when you look at Ireland, it's not only that contingent liabilities from the banking system crystallized, it's also that tax structure and the tax system needed a complete overhaul after the implosion of real estate and financial services. But the overall message is here that, both on the macroeconomic and the fiscal side, significant progress has been made. And that's a chart that reflects how the Euro Area debt crisis compares to the Nordic banking crisis in the 1990s and it gives you an impression how long such crises take until the GDP level from the pre-crisis stand is reached again. In case of Sweden, it took 4-1/2 years, in case of Finland, 7 years, and keep in mind that both countries had, in a way, the advantage of a flexible exchange rate which made the adjustment to some extent easier.

And you can also see that the crisis increase so that's the purple line here to some extent it’s for an advanced economy unprecedented in terms of severeness here. So the travails are still ongoing in Europe but there is adjustment. I mean, I'm not prepared to call the Euro Area debt crisis over but certainly this feeling of an imminent acute crisis has, to some extent, vanished. And here the role of backstop facilities comes in. Basically, there are two phases. There is the pre-Draghi situation and the post-Draghi situation.

The pre-Draghi situation was characterized by that fiscal backstop facilities where meant to really address the issues and just were important steps. The EFSF in 2010 now replaced by the European Stability Mechanism since 2012, but given their size, there are appropriate to address issues of relatively small countries like Greece, Ireland, Portugal, Cyprus, potentially Slovenia here. They also play a role in addressing specific issues of large countries, like in Spain, with the bank recap package there, but they are clearly inappropriate, in our view, to address the issues of large sovereigns if they face liquidity issues.

I mean, the two big countries here that in summer 2012 came into the focus of financial markets are Spain and Italy, and if these two countries have issues, you need a monetary backstop facility just given the size of the outstanding debt of the two countries. A country like Italy, it's probably not even meaningful to apply a strategy to take Italy out of the markets for three years. I mean that would create--that's not sensible economically, but the strategy of having a tandem of ESM and the OMT program by the ECP clearly with insight made a difference for markets and our one reason for the relative market column that we've had since last summer of 2012.

And that's also reflected in how our yields have developed over time so what you can see here is that until August 2012, we had phases of very significant spread increases here, and you can also see that there is a significant correlation between the different countries here. I mean, we certainly had shocks in 2013.

We had the Cyprus crisis, which was very significant, we had issues in Slovenia, we had a kind of mini-crisis in Portugal with the constitutional court there which raised concerns, and quite recently, we had a quite tense situation in Italy again, where it was not entirely clear whether the [inaudible 1:15:52] government would survive the confidence vote there. And at all the occasions there was no lasting widening of spreads here so that's clearly different, but I mean there are two situations in your area that in my view needs to be distinguished.

One situation where small countries get into trouble and small countries--basically all countries apart from the big four here: Germany, France, Italy and Spain. And then there are situations where really large countries would come into significant problems and what that could create was obvious in summer 2012 also, when Spain was in a very difficult situation at markets and also discussions about Italy started. So we would certainly think that when one of these two large countries would get in a program, certainly a remote scenario for us, but one that we cannot entirely exclude, then that would be a shock of a different magnitude.

And similarly if there's a scenario in which countries like Greece of Cyprus would exit from the Euro Area, that would be unprecedented and would question the irreversibility of Euro Area membership, so these are the [inaudible :17:35] that the title of my presentation speaks about.

Progress in the banking union is important because we also have the issue fundamentally here that we have a situation of fewer area fragmentation where the funding cost in the powerful countries are significantly worse than in [inaudible 01:18:11] and that's something that has the potential to provide headwind for real convergence in the Euro Area. I think that's key for the viability of the Euro Area that we eventually see a convergence from powerful and core countries.

I would leave it there for the moment, and for us, we're certainly not currently in a way the acute phase of the Euro Area debt crisis has vanished. But if we want to describe this new Euro Area normal in a way, it remains fundamentally and structurally a very difficult situation and challenging situation because it's characterized by a low growth environment, so we have a resumption of growth but it will remain subdued for a longer period time. We have a situation of relative market calm but as I pointed out there is certainly the risk that [inaudible 1:19:24] could reemerge if events would happen.

It's also; thirdly, the Euro Area reality is characterized by very high debt levels. If you go through the slides that are in the package, you will find that debt to GDP, for instance, has not leveled off in the countries. And finally, the new normal in the Euro Area is still characterized in many countries by fragile banking systems and that's something that's also, you know, has the potential for crystallization of contingent liabilities plus provides headwind for economic activity. That is the new environment in Europe as we see it.

Jeromin Zettelmeyer: Thank you very much. It is a pleasure to have this job. It is great. I mean, basically, Adam and I are free writing on these nice presentations, right? So just like Adam, I do not have PowerPoint but unlike Adam, I'm not good enough to simply speak without notes, so I did come up with some notes for myself. So I think what I'm going to say is, well, first of all, I'm obviously not speaking for ERD. The Peterson Institute couldn't care less if I was speaking for them or not except if I were to say anything against free trade which I'm certainly not going to do. So basically, I'm going to be a little more perhaps, pessimistic a little more controversial than what we have heard so far, but not so much that it's really going to get me in trouble with anyone hopefully.

So I'm going to essentially go a little deeper where Dietmar kind of left it off, namely what characterizes the new normal and to what extent is the new normal a satisfactory situation of its kind. It's pretty obvious that it's not right, but to what extent can we expect the new normal to turn into a more satisfactory situation if just left by itself? So just quickly to recap, we have seen the stabilization; that was what the presentation was mostly about; just to run through the main points again, there has been a lot of fiscal adjustment. Periphery spreads have come down at approximately half since mid-2012 which is good. They are also more stable and now in response to this, not so negligible shocks. Many of us were pretty scared about Cyprus for example and nothing much happened. So that's good and the current account deficits have mostly disappeared and we're now in surpluses in Italy, Portugal and Spain.

Furthermore, good news is also that, except for the case of Italy, these recoveries in the country's current accounts have been mostly export-driven. Unit labor costs are down in all periphery countries again except Italy. This is, by the way, very nicely elaborated in Dietmar's note that you did not really expound on here but I would encourage you to read it. It's very short and it gives you exactly what you need to know. And of course, we have had an incipient recovery, the PMIs have turned expansionary for the first time for since a very long time, and we have had modestly a positive "growth." And according to the wheel, all European countries or all Euro Area countries except for Cyprus and Slovenia are expected to return to growth next year. So that's sort of the good news.

Now, what is the bad news? The bad news is that, in my view, that if you like this …. There is a new post civilization steady state which reflects a new normal in the sense that it is the result of an extremely successful response, and extreme success to very large, very unorthodox policy instruments, like the OMNT that effectively been effective at breaking with the panic. And so, after these instruments have been played so far, there isn't a whole lot of powder left and yet that new steady state that we're left with is not a terribly satisfactory state of affairs. So let me just run down this a little bit.

So first, peripheries spreads are still very high. They are about 300 basis points compared to an NCS spread, compared to what 100 bases points for the core, sovereign yields are about 300 bases points over bund still the financial fragmentation phenomenon is not being reversed. There's a lot of concentration of sovereign debt on domestic balance sheets. They are much higher. SME lending rates in the periphery, this is clearly correlated with bank CDS spreads so there's a direct link from the sovereign to bank funding conditions to SME lending conditions to the shelf SMEs complaining about access to finance is much higher in the periphery than in countries like Germany. There is a sense that we don’t quite know as subject to the asset collegiate review of the ECB, that banking problems are concentrated in the periphery countries. We certainly can see, just from the basic statistics, that banks with [inaudible 1:25:15] one ratios that are close to the regular minimum are concentrated in countries like Spain and Italy. Reductions in household debt to GDP have been very modest so far with the exception of Ireland so household debt remains high. There have been further increases in corporate debt to GDP ratios in most Euro Area countries so that thing hasn't even started to come down. Sovereign debt levels continue to be very high. Unemployment is in excess of 15% increase in Portugal.

Youth unemployment is stratospheric in these countries and even the Euro Area average is in the order of 25% and the so-called recovery in 2014 is going to be growth in the area of 0 to 1%, and even over the medium term, the wheel projects growth rates in the Europe in the order of 1% to 2%. So if you were to, in some sense, extend those nice lines that you had in your benchmarking chart, I think what would come out roughly is that this crisis is going to take about twice as long at least to unwind as the Scandinavian crisis that you mentioned.

So now, even with this kind of pretty dark picture, I think you can pick a few which is because the situation is not fundamentally stable as we have seen from the fact in which financial markets have reacted to these shocks lately. We need to be patient but we will eventually get there. So I think there is a predominant view in Europe right now that we are at a point which maybe doesn't quite meet what Mark Carney would call sort of take-off speed for Europe. Europe looks a little bit like the Concorde that crashed in Paris in the sense that it did take off but then we don't quite know yet whether it's going to go up or down. So we haven’t quite reached that takeoff speed, but there is sort of a confidence that because it's a fundamentally stable situation eventually, if we're just patient, the takeoff will come.

In my view, that is the really important question. The reason why this is the important question is that, remember after all, we are talking about rich countries. So if it were true that we have a stable situation that all we need to do is wait for another ten years for things to recover, that's much less bad than, say, the last decade in Latin America where waiting for ten years means huge welfare losses. In Europe, it's waiting with nice street cafes, nice leisure and hopefully solid social welfare systems that can really minimize the damage for the poor. So the question is, is that the situation in which we are in? I think there is a sort of majority view in I would think, in Brussels and probably in many of the core countries that that's the situation we're in. And here is where I’m really not sure.

I'm not sure that these post stabilization steady state, this new normal is self-correcting over time. And so to put the question a bit more precisely, so assume that stability is maintained, say via the OMT, and assume that the world economy outside Europe does not take a big turn for the worse. Like a default in the US or something like that, can we expect both continued recovery and slow improvement of these post stabilization steady stage in the direction of healthier balance sheets, financial reintegration and improved competitiveness in the periphery? And so my personal answer to that is probably not. Essentially, the deep reason behind that is that there are some really inherent fundamental tensions between recovery and these structural improvements.

And some of them are just a consequence of the dynamics of adjustment, and balance sheet and demand, so it's really just about macroeconomic fundamentals and the way in which they connect whereas one is, in my view, a policy induced reason. So I'm going to just list these four tensions, so the four reasons why the situation may not be self-correcting. So the first one reflects a causality from recovery to the undermining of the supposedly structural improvements that we have seen right now.

So one thing that the Moody's paper that is in your folder very nicely shows which wasn't particularly emphasized in the presentation but it shows very nicely that except for Greece and Ireland, the unit labor cost improvements that we have seen in peripheral countries reflect proactivity gains due to labor shedding and not wage reductions. Now, Greece and Ireland are two pretty important exceptions, but remember, these are particularly in Greece, completely depressed labor markets. It just reflects the huge unemployment. What is really not clear, except possibly in the case of Ireland, is whether any of these competitiveness gains will survive a cyclical recovery. In that sense, there is a tension between recovery and these adjustment gains. It's going to be very hard to have both.

The second tension goes the other direction. This is about structural improvements undermining the recovery and so what have in mind here is particularly is the deleveraging and the balance sheet adjustment. So that has barely restarted, and unless we have much more supportive demand conditions that somehow come from outside the private economy, so they could be either public, the public demand, or it could be demand from outside the Euro zone, this is going to delay recovery for several years. I haven't talked to either the Euro Area team at the Fund or the WEO team. But I would imagine that the reason why we still have in the WEO 1% to 2% growth rates projected in 2018 for those countries has to do a lot with just the drag from this coming down of many years slowly from these highly leveraged positions.

Now, an additional worry, and here I am completely in the dark so people like Nicolas Véron or Jacob will know more about this is that I'm really not sure to what extent one would also have to fear feedback from stagnation to new balance sheet problems. So far we've only talked about the existing balance sheet problems and deteriorating asset quality of banks. In other words, what is the stall speed, if you like, from the perspective of bank balance sheets; when do you start getting a new flow of non-performing assets and what is the critical growth that you need in a place like Italy to prevent this? If that critical growth is something like 0.5%, then it really matters that we should press a little bit in the accelerator as far as growth to prevent that from becoming an unstable system again.

And then the fourth and most insidious trade-off, in my view, the one I'm really most worried about and I really don't know very much how to deal with it, is the supposed tradeoff between the structural reform and high unemployment. Actually, Adam briefly referred to that when you were talking about the ECB and Berlusconi, but I think there is a pretty entrenched view in places like Germany and also at the ECB that structural reform will only continue to happen in the peripheral countries if unemployment stays high and if growth stays low. In some sense, the continuing recession and continuing social suffering is the price that Europe has to pay for structural adjustment, and if that's true, then by definition, you can't have both. You can't have a recovery and you cannot have both structural improvements at the same time.

What worries me is that this position is actually supported by some intellectuals from peripheral countries. There's a very nice paper by Samuel Bentolila a Spanish Labor Market Economist with two colleagues that shows the duality of labor markets in Spain. This really means that you only get the political economy if reform going if unemployment rates go above 25%, because that's only when the people on the permanent contracts really starts hurting, and those are the ones that have the political influence.

So the bottom-line, and I'm almost done, is we could see a new normal which I would define as this combination of stagnation and partial adjustment that is not self-correcting that could persist for a long time and is not ultimately very stable. And I even started talking about the asset quality review next year and what that might do. Okay. So very briefly, so what's my recipe? What would it take to combine cyclical recovery and durable structural adjustment? Well, of course, all the good things that the IMF is calling for. So roughly the answer here is: we need more structural reform in the periphery. We need steady and sufficient progress towards better Euro Area institutions particularly the banking union, particularly using the resolution mechanism. And we need more accommodative monetary policy because clearly there's a problem of lack of demand in Europe as a whole and that's how one has go about it.

Now, this is all good and I agree that this is all necessary but it's still not, in my view, a terribly satisfying answer because it ignores some of these tradeoffs that I've tried to point out, particularly the tradeoff between recovery and structural reform. And so then I'm thinking that perhaps we need some additional instruments for the short run and the idea here is that they would have to be targeted specifically to dealing with this tradeoff between adjustment and recovery and structural reform and recovery. And so what could that be?

On the one hand, I think, from a geeky economist point of view, there's just a pretty obvious case for fiscal instruments that are, in some sense, targeted to take account of these tradeoffs and the differences in cyclical positions. So what we would need is a fiscal expansion at the center that would support the relative real exchange rate adjustments. So rather than forcing peripheral countries to adjust by creating large unemployment, you can get the relative price adjustment to essentially differential inflation rates between the center and the periphery. The fiscal affairs department of the fund had very clever ideas about fiscal reevaluations in the core versus fiscal devaluations in the periphery. I wonder what has happened to that.

I am pretty sure that Germany doesn't want these things. I think it was tried for Portugal at least at one end, but probably we would have to push much further down that road. And then the last point is; if it is really true that structural reforms aren't going to happen by themselves on a normal recovery path. Then maybe the only way we can avoid a process of a ten year stagnation as a price for structural reforms in the south is to supplant this sticks approach that are supposed to prod the south into structural reforms by a carrots approach. And so a version of that could be something like the German Consul of Economic Advisers ideas of the Debt Redemption Pact that has a very clear explicit structural component in it. It's not just about essentially subsidizing debt issuance at the margin in return for keeping a particular fiscal path but also in exchange for continuing structural reforms. Thank you.

Lucio Vinhas de Souza: Thanks so much for the two of you for those [inaudible 01:38:02]. Now we would like to complement the wonderful presentations of Dietmar and Jeromin with a round of questions. So we have a rolling mic. So please. And we are a go now. So [inaudible 01:38:30] please?

Gentleman 2: Thank you. This is a question to basically both of you, but perhaps even more to Jeromin. Adam introduced you as you made great work on that restructuring and related issues and if I listen of all of what you said, you simply imply that the debt overhang problem both into public private sector could be resolved at least on the targeted remedies that you mentioned. You did not list the possible debt restructuring. Now my view—so my question is indeed to both of you is that basically how do you see that countries like Portugal, not to mention Greece, but Portugal and even perhaps Italy would be able to repay all public debt or in Spain, the private debt problem.

Jeromin Zettelmeyer: The reason I didn’t mention debt restructuring is because it's not an easy topic to talk about. Sovereign debt restructuring, right, it doesn’t play a very obvious role in getting out of this new normal structurally unsatisfying steady state. The reason for that is that first of all; no country is quite in the situation of Greece which was just blatantly obvious that they had to do PSI. Even though what is emerging as actually like the implicit European strategy towards these high debt cases is unsatisfactory, it's quite hard to come up with something better. So we'll give you something better but it's not hard to get there. So the implicit European strategy, I think, is to do what is being currently tried with Greece after the PSI, with countries like Portugal, in a low-key way and with a biggest chance of success which is to effectively generate MPV official debt relief by extending maturities and through very low interest.

So there is a combination of hope that these countries will recover fiscal adjustment and then some gentle debt relief from the official side which is not made very public and does not take the form of upfront debt reductions. The reason why this is not very satisfactory is because it prolongs the debt overhang of these countries, so you are left with a situation as a private investor where you are not quite sure how the effectively permanent low-level negotiation between the country where you are in and its official creditors is going to pan out. And it might pan out in a way that suddenly much higher taxes are required, which is not good for you. It might pan out in a way that perhaps PSI is required after all which also may not be good for you.

So it creates a situation of uncertainty which is not good for investment and private recovery. Now, the problem is that I do not think that there are easy PSI options on the table left after Greece for two fundamental reasons. The first is that we've had a further concentration of sovereign debt on the balance sheet as of domestic banks, as you know, and so the net debt relief that you would get for the country as a whole is not that large compared to the damage that you would do impose on your own banks.

Or, to put it differently, you would need quite a lot of funds for recapitalization which causes a new fiscal and financing problem. Or you need some sort of much bigger national debt restructuring that just deals with bank balance sheets and sovereign balance sheets at the same time and it is not entirely obvious to me that you could do this without hitting depositors and we all don't want to go there. So that is the reason why that's not a very attractive scenario. What is my proposed solution? I'm very sorry to come back to it, but I do think that it would be better, rather than having effectively a strategy of ambiguity where nothing is exactly committed, countries are left a little bit in the uncertainty of how much of report will be granted at which time for which price.

I think it would be better to replace this situation with much more clearly specified support in exchange for much more clearly specified fiscal and structural reform targets. And that's essentially what I call sort of my version of the European Debt Redemption Pact. So we would be talking about effectively long run adjustment programs that would be supported, in effect subsidized, at least on a flow basis by guaranteeing new debt insurance.

The reason why I think that this is sound is because it leaves the PSI option on the table in case things go bad because you're not guaranteeing the entire outstanding sort of debt. You are only guaranteeing new issuance and at some point you stop with the guarantee once you have reduced a debt to 60%, the non-guaranteed portion.

Lucio Vinhas de Souza: Thanks Jeromin, Dietmar

Dietmar Hornung: When we have in the periphery quite different countries and Greece is a clear outlier here in terms of the economic weakness, the institutional weakness of the country. I mean, if you compare it to Portugal, for instance, the institutional strength in Portugal is quite different. On the economic side, progress is made. In the case of Ireland, those economic strengths, institution strengths turn out better. The PSI for Greece does not necessarily imply that that's good for the other countries as well.

Currently, we're particularly looking at Ireland and Portugal here and both have been quite successful in their programs. For Ireland, they complied with their targets. In the case of Portugal, they complied to modified targets but it needs also to be said that the fiscal targets for Portugal were much more ambitious than for Ireland on the first occasion. So both countries have a vision now to exit their current programs. In the case of Ireland, we see on the constructive view that's a plausible option so in that context obviously, these guys, in my view are completely off the table.

In the case of Portugal, given the economic growth outlook, debt sustainability in the long run and solvency is not as clear in Ireland where we expect higher economic growth going forward. But again, as [inaudible 01:46:25] mentioned here, the incentives are not there because first of all, the debt that's held the private sector is not as large as it was. Top off that it's helped by domestic banks and when your strategies here is for re-access of markets, then you would just destroy the markets for quite some time. We just published this week in our sovereign [inaudible 1:46:47] series a study on the experience of countries that defaulted and their ability to reaccess their markets and we found that it takes a prolonged period of time of 4 to 6 years until a sovereign can start thinking about reaccessing the markets so it's not really an option here.

So, I think, in Europe, we are in this continued model through and a part of the model through on maturity extensions that lower the burden of the existing [audio gap 01:47:33] and that's, in a way, a path that goes hand in hand with these elevated event risk here. And to some extent, it's also probably necessary to have this pressure on the governments to improve their fundamental credit profiles in terms of economic strengths and institutional strengths. In a way, that's the setup in Europe which is clearly not ideal from a credit worthiness perspective because this relative or elevated inventories is quite unusual for countries that some of them or most of them are investment grade rated but that's the consolation as we see it in the Euro Area.

Lucio Vinhas de Souza: We have a question there with Richard. You raised your hand. I remember it clearly.

Richard Canter: I did a while ago, yeah. Sorry. I think, if there's time for one more. We ask a quality review, if it does reveal large holes in balance sheets, the backup facility question, what difference does it make if it comes from national funds, ESM, or bail in. And how would you handicap those sources or other sources?

Jeromin Zettelmeyer: The way it's envisaged now is certainly not ideal in terms of breaking the link between sovereigns and banks. I mean, anyway that's probably not possible anyway, but there is still a strong link here and the intention from policymakers in Europe is, first bail in, then national governments, and then the ESM cavalry at the end comes. But at that point a lot of damage potentially has been done on domestic markets. I would imagine here that there would be a difference of treatment between small and large countries, so small countries really have to comply with the intentions here.

You already mentioned Italy in that context. Obviously, here we have a sovereign given at the very low potential growth there where the fiscal space is probably close to zero at 130%, so here we, in a tail risk scenario in which recapitalization of banks would be necessary and would not be done by the private sector there. It would have an issue, but I could anticipate that in such a scenario there would be flexibility on the inside.

Lucio Vinhas de Souza: I think that we have time for one last question. Please, Fred.

Fred: I read both of you, particularly Jeromin, as saying that the most likely outcome is what I would call high-level stagnation indefinite future. So three questions: (A) is that a fair characterization of what you said? (B) Is it socially stable? And (C) is there anything by way of a major external positive shock that could improve the situation in a favorable direction? The only thing I can think of—and I'm not even sure that would go too far—is a depreciation of the Euro to say parity with the dollar. And try to get a big boost to exports of the region as a whole realizing a lot of that would be Germany, but still a fair amount with spill over to the periphery. Those are three question if the characterization is right and that is really my primary question.

Lucio Vinhas de Souza: I would ask Dietmar to start the reply but just as a point to the Euro roughly ten years ago was actually 0.7 to the dollar. So it went even lower than that. It's a free-floating currency.

Jeromin Zettelmeyer: Economic growth in the Euro will be low for the foreseeable future but it had been below pre-crisis if we abstract from these bubble economies in the periphery. And Italy's used to low growth so, at least from a creditor's point of view, it's not necessarily an issue, but I fully agree that a low growth environment is a prone to shocks because low growth means there is pressure on government balance sheet to fiscal performance.

Then we have the issue of asset quality in banks also affected. And then we have the issue of a social cohesion or the lack of social cohesion when we talk here of unemployment rates of 25%, youth unemployment 50%. That's maybe stable but maybe not stable, so if there's a political event that could create issues, so that's why we talk about this elevated susceptibility to events within the Euro Area for the foreseeable future.

Dietmar Hornung: I agree with the characterization. I think that two things--the only tweak I guess is it is stagnation at high level but in the sense that these are wealthy countries. It is actually stagnation that, I don’t think that's inherently stable, right. It requires quite a lot of fine-tuning, quite a lot of sort of manual steering to keep them there, and so there is particularly with this idea that you do not want to, in some sense, deliberately reflate too much because if you do, you would be cutting short the structural reform process in the periphery, right?

So that requires really keeping this plane at stall speed to make this process happen. That's not a very comforting--in terms of potential volatility and stability and crisis risk, that's not a very comforting idea. So one thing that could take us out of this is a large external positive shock, but then we would be presumably losing incentive for structural reform. So that's not an entirely satisfactory state, so I think that if you want to have both recovery and continued reform, you really have a pretty much bigger onus on policymakers of being creative than we have seen so far. I don’t think they will do that necessarily on their own and I sometimes think that maybe things got a little worse, they would get more creative and maybe we would be for the better.

Lucio Vinhas de Souza: Okay. We have already exceeded our time slot by a full quarter. I would like to ask all of you to give a round of applause to our speakers for their performance. On behalf of Moody's Investor Services and of the Peterson Institute, I thank all of you for attending this event. This is part of an ongoing series of joint activities. The next interaction of these enhanced relationships will actually happen in Hong Kong where we're going to have another event on 6th of November of this year. For those of you that love international travel, we look forward to have all of you there, too. Thanks so much.