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Moody's Investor Service–PIIE Sovereign Economic Panel
The European Union: Challenged and Poised for Change

Opening
Adam Posen, President, PIIE

Opening speech: The European Union's investment and growth model going forward
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Adam Posen: Good morning everyone. I'd like to welcome you back to the Peterson Institute for International Economics and also to welcome our friends and fans viewing online. People will be continuing to come in, but I wanted to get us started out of respect for lead off speaker's demands on his time this week. I'm Adam Posen, President of the Peterson Institute and it is my distinct pleasure to hold the latest in our semiannual series of sovereign economic panels that we do jointly with Moody's Investors Service. These tend to be very high substance events bringing together analytics from a markets perspective, analytics from our perspective, people from the officials sector.

We have a particularly good version of that today focusing on Europe representatives from Sweden Central Bank and the finance ministry embodied in one person. Later today we'll be having all of our friend, Vitor Gaspar from the Fiscal Department of the IMF and of course, former Finance Minister of Portugal. But we start off today with the question, we've tried to put out the title, *The EU: Challenged and Poised For Change*. That this is a time when, God willing, we hope that crisis and European commission willing the crisis is abating but that there are clearly new macroeconomic pressures bearing down on the European project and on the Euro area and clearly there are also, with the election of the new commissioner, the new team of commissioners and the new European president, the new European cycle or semester I think Jacob has taught me to say. There's a new agenda and a new spirit in Brussels and elsewhere.

So this is a very exciting time for Europe. We hope exciting in a positive way. And no one could be better poised to talk about that than our keynote opening address by Marco Buti. As all of you know, no doubt, Marco Buti has been Director General of Economic and Financial Affairs, ECFIN, at the European Commission since 2008.

So he came in just in time for all the good stuff. He, of course, had previously spent the previous 21 years at the Commission in a variety of roles. He was an Economic Adviser to the Commission's president until 2003. From 2003 to 2006, he was Director of Economies of Member States, obviously the most sensitive position at the Director General ECFIN and he was Deputy Director General in September 2006.

He has his degree from Oxford. He's taught at a number of universities. He's a longtime friend of the Institute and has always responded to the both support and criticism that we and others have offered in a calm, engaged manner but I really look forward to him putting out his agenda and his vision at this point of challenge and change for the EU. So Marco, thank you so much for joining us.

Marco Buti: Thanks. Thank you very much, Adam. Okay, thank you very much, Adam and let me thank the Peterson Institute and Moody's for having organized this and for inviting me [inaudible 00:03:23] here, Adam. We are, as Adam said, at a crucial juncture in Europe. Actually we have been at a crucial juncture now for a couple of years.

Every time we come we'll say this is really the moment but we are engaged in what one can call, let's say a triple transition. We have a transition on the economic and financial front, basically moving from a period of acute stress to challenges which relate mainly to the—avoiding the risk of erosion in terms of economic performance and also social sustainability.

This is the first transition. There is an institutional one. Adam referred to that. I mean, we're going to have a new team in Brussels, a new college of commissioners and a new president of the European Council, so an opportunity for a fresh start with a strong endorsement of the President-elect, Juncker, on the part of the European Parliament following the European election so tackling somehow the democratic accountability issue that is often discussed in Europe and we are in the process of going through the hearings in the European Parliament for the appointments of the new commissioners.

Yesterday was an important day because the economics team at the college level, Mr. Moscovici, Lord Hill, in charge of financial regulatory issues and the two vice presidents have been formally endorsed by the European Parliament so an important moment. The process is now finished, but let's say we are reasonably optimistic now that the new team will be in office on the first of November.

So this is the institutional transition and then we also have a political transition. We clearly see that in a number of member states, even just take the largest ones, there is an important debate on the orientation for economic policies and let's call it like this, the reformist credentials of the governments in Italy, in France in particular, I think are being tested these very hours in a sense.

So for different reasons I think it will be—it's a crucial passage to something which would make the overall policy stance and policy strategy in Europe more consistent, adequate to tackle the challenges that I'm going to talk about today.

I think the key word already in the presentation of his strategic guidelines, I'm talking about President-elect Juncker in Parliament has on the economic agenda revolve around investment. So I would like to go through with you the challenges related to investment and you can see that through that we come also to the issue of, let's say, the growth model that is the title of this conference. So we're going to look at the impact of the crisis on investment, the underlying factors hampering investment and then the possible policy avenues to tackle these issues.

I think what you can see here is the behavior of GDP across the Atlantic, so focusing on the Euro area and the US. So the type of recovery or non-recovery that we are witnessing in Europe, the past recovery over here I have selected an episode which is the beginning of the 90s because it was there again, a very severe shock. What you can see is that for the US there is a relatively parallel behavior between the present and that episode there, whilst for the Euro area after the recovery which was indeed similar in the initial quarters, there has been stalling then.

I mean, President Draghi mentioned this also last week, qualifying it is a loss of momentum in the recovery. You can see that this is clearly a pretty unsatisfactory behavior that we need to tackle. And by the way, it is not that the benchmark of the US is a particularly stellar one. I mean, discussion on this side of the Atlantic is also of a muted recovery. So here again, it's not that the benchmark is set so high that we cannot meet it.

Now the account to investment, because I think a lot that underlines the performance or the lack of performance of the previous slide is very much related to investment here, I have selected equipment investment taking away the housing because we know that that bias is the picture considering the irrational exuberance of the pre-crisis period across the Atlantic in the US but also in a number of European countries.

What is interesting to see here is that when the shock of the financial crisis hit the real economy in 2009, if you focus in the last two lines you can see that the US and the Euro area actually were hit exactly by the same amount. So there was a fall of investment by almost 20%, the same across the—obviously, there is a bit of differences within the Euro area but by and large the shock was similar. What has then characterized the following years is a recovery which is reasonably robust in the US but here again; let's say the constellations on the benchmark that I made before for the GDP applies also for investment.

If you talk here to economists in the US on the performance of business investment they tell you that it's a very muted recovery. So once again, one should put things a bit in perspective. But what you can see clearly is that you take the following period until 2013, there's basically almost no recovery in the Euro area and quite a robust recovery in the US.

These figures which come from our spring forecast, so back in April, where we were let's say reasonably optimistic the recovery though fragile and muted would be underway. So the forecast for 2015 reflected that reasonably, let's say cautiously optimistic mood, when we are going to come with our forecast of autumn, which is going to be published in the first week of November, we are going to see these figures revised down because the recovery has clearly proved more complicated and even less buoyant than these very moderate numbers.

Now the focus on investment and particularly investment in equipment is attractive because it has both a supply side and a demand side component. This helps also politically because we all know that in Europe in particular, that some countries are more sensitive to the let's say short-term cyclical consideration so the impact of investment in order to close the output gap. Other countries, they are much more concerned about the longer-term performance and equipment investment actually affects investment in general, it affects both supply and demand.

What we have here is our estimates with our production function of the implications of the fall in the ratio of investment to potential output on to potential growth. Basically what this figure tells you is that the somewhat three points reduction in the investment to GDP ratio which occurred during the crisis has slashed almost half a point of potential growth.

Here we have with all these models somehow there is [inaudible 00:13:07] reverting looking forward so this has to be taken with a certain caution. It is not that it would be—everything will go back to normal without the policy action. But this is the picture that we have now and the impact of the fall in investment ratio.

Clearly what you can see here in the pre-crisis period was the spike of investment and some of the elements I'm going to come to in a moment, which are behind the deleveraging that we can—that you can see are also related to possible over investment in a number of countries in the pre-crisis period.

What you can see in this picture here is that the situation is pretty differentiated across the Euro area. Here we have the Euro area average and the subset of stress countries. So we take the vulnerable countries, we have Italy also in and what you can see is that in the pre-crisis period the investment ratio was considerably higher in what have become stress countries and this is also related to the fact that these countries were in a catching up period, so it’s normal that you have a higher investment ratio compared to the others.

And you can see the investment precipitates quite substantially during the crisis and so the full which has—that you observe in the Euro area average is considerably more and considerably steeper in the case of vulnerable countries. So they have taken a hit, which is much stronger than the other countries.

Now what are the factors underpinning this? What explains this performance of investment? I think I have listed here and I’ll try to document briefly five possible causes. One is economics 101 accelerator, so the link between investment and demand. The second what I alluded to a moment ago, the need of deleveraging a number of countries and a reduction of overcapacity in pre-crisis booming period, financial fragmentation, the type of consolidation that we have observed and finally a more contested, the issue of the implication of uncertainty on investment.

Now going through this, here is the impact of the accelerator. What you can see here is that the accelerated model fits Europe reasonably well. Obviously when we talk about the accelerator we have to be careful in not, let’s say, establishing or being let’s say too sure about the causal link between the investment and demand because the two things are closely interconnected but clearly, the fact that you do not have growth prospects coming forward, having this come down, reduces let’s say the trend level, equilibrium level of investment.

On the deleveraging side this is pretty striking picture, you can see that what I have here on the X axis and on the Y axis is that on the X axis you have the change in the debt on nonfinancial corporations essentially in the pre-crisis period. It goes through to 2009 but so the debt accumulated then, so the more you have accumulated debt then the more you need deleveraging in the post crisis period or during the crisis. And you can see on the Y axis the change in nonresidential investment. You can see a very, very strong negative correlation. So those who have been affected the most by irrational exuberance in the pre-crisis period, the more have witnessed a slump in investment in subsequent period.

I think we'll jump this up. We'll go to the third element which is financial fragmentation in Europe. And in here there are different measures, but what you can see is that we hoped by creating economic and monetary union the Euro as a supplement to the—as a coronation say of the internal market for financial services that would lead to a convergence of credit and borrowing conditions and this has happened to an extent in the pre-crisis period even too much in a sense. And then during the crisis, financial fragmentation hit the Euro area and you have countries like Italy, Spain, Portugal, not to mention Greece, here, which would go outside the Y axis that have clearly suffered considerably and have seen credit conditions diverging substantially, which has certainly hit the investment prospects [inaudible 00:19:02], especially SMEs borrowing.

What has been done on the public investment also has an impact here. What you can see is the G20 and within Europe, the EU coordinated fiscal stimulus, it has been quite substantially boosted in 2009 via the coordinated fiscal expansion but then public investment has been retrenched quite pretty strongly in the following year. So this also has had an impact on investment [inaudible 00:19:41] by reduction in public investment. So the type of consolidation, the quality of public finance has been hit by cutting where, at the end of the day, it's easier when you do the coordination, which is on the investment side rather than tackling the vested interests which are behind other types of public spending.

And finally, I present here a graph on behavior of investment and uncertainty. This is the uncertainty indicator computed by Nicholas Bloom [inaudible 00:20:19] at Stanford and you can see there's a pretty strong correlation, especially during the, let's say the crisis period. This has— in certain has been reduced in the past few quarters so one could expect that this factor here compared to the existential uncertainty in the midst of the crisis that would then recede and the impact on investment becoming, let's say important.

There is a discussion out there of how robust this is in terms of an explanation for the behavior of [inaudible 00:21:02] unless some say that okay, it is the causality equals the other way around. I just presented here this seems to be pretty robust for the Euro area as a whole and for the European Union when you go down and look per country, the relation becomes less convincing. So these are by and large five elements which underpins the behavior of investment. So when you come, to the policy agenda at the end of the day the issue is how to tackle each one of those underlying reasons.

So for the policy avenues this is what we are working on. There is an issue here of demand. I think after a long time where it was—this was a pretty dirty world in Europe, I think there is acknowledgment that demand is an important factor to put the accelerator into reverse. We have to work on structure reforms in particular on product market reform to unlock investment opportunities. Financial fragmentation by completing banking union, I think also but improving access to long-term finance for investment to reduce the excessive weight of banks in Europe here. The proposal by President Juncker, which has been outlined in his speech at the European Parliament, to move towards a capital market union I think is a far reaching one.

When it comes to public finances, I think there is a need to boost investment where there is room for maneuver and where there is sufficient fiscal space boosting investment, I think is important but using this fiscal space for those countries which do not have fiscal space, I think the issue is composition, reviewing the composition of public finances, public expenditure. In particular, you all have seen the chapter in the *World Economic Outlook* on they say self-financing public investment. I'm not ready to buy fully that those, let's say the Laffer curve for public investment, but certainly it indicates that the conditions out there are highly conducive to stepping up public investment, investment infrastructure, especially where you see example of decay in the capital stock in a number of European countries.

And I'm talking about Europe, but there is a discussion and an agreement also at the G20 level where in preparation of the Brisbane action plan investment is going to be one of the key pillars. So action is needed. A national European, I think at global level and I think moving several levers at the same time would be the right strategy at this juncture.

So what could be done at the national level? I think we need to have a more balanced adjustment. Here growth for any fiscal consolidation to increase public investment using the fiscal space where it exists, as I mentioned before. And on the structural reforms implement here got a bit in the jargon, the country-specific recommendations under the European semester. So it is the cycle of coordination, the civilians that we have in Europe.

On the fiscal side I think here it basically says what I have indicated. Fiscal stance overall becomes considerably more neutral than it has been in the past couple of years, so less drag from fiscal policy at the present juncture. I think the possibility also to improve the impact on investment by reviewing the composition of public finances. Taking into account that you know debt, you see it on the right hand side there is at a high level and is not projected to come down, I think any time soon in earnest.

I think we also have to move on the structural reform side. Here you see indicators of approach to market reforms using OECD data and strictness of EPL. I think the main message from this is that the degree of reform responsiveness is much higher in peripheral countries than in large Euro area member states. This is in part due to the fact in some of these countries we had EU-IMF programs. We've pushed precisely those structural reforms, but certainly it's only with countries with [inaudible 00:26:32] against the wall that reforms have been implemented, much less for countries in a more relaxed position.

And here, the degree of reform responsiveness is definitely lower in countries like France, Italy, but also Germany. Not much move you can see on the labor market reform side. On the part of core countries, you can see improvement instead in peripheral countries. So this is also the direction where to go in the next months and actually this does not capture the recent discussion that you have in countries like Italy where I think there are important and ambitious reforms in the labor market which hopefully will be implemented soon. These are the recommendations that we are issuing and they tackle a number of these matters. I don't want to lose any time on this.

At the EU level the approach that we are taking in designing the Juncker investment package, which the commission will issue as soon as the new college takes over. So in the next weeks I'm expecting before the end of the year, is to have a pretty comprehensive approach to remove the regulatory bottlenecks to investment.

Here, the focus is going to be essentially on investment in network industries, so telecoms, transport, energy and we know that there are sector regulatory barriers that hamper investment. We have to make better use of the available resources and boost them, EIB in particular, European Investment Fund as well, better harnessed in the EU budget, improve the access to long-term financing and also the completion of banking union to deal with financial fragmentation.

I mentioned there also the ECB, because at the end of the day the macro picture has to be consistent and clearly with—if we get stuck in a very low inflation equilibrium, the rest is not going to go through, even with some active push on the part of the European authorities.

And finally at the global level this is the discussion in G20. Actually as soon as I finish here I have to go back to the G20 deputies and I apologize already because we are discussing precisely this point here and I'm lead speaker so I cannot dump them.

So in the Brisbane summit the G20 aims are coming forward with the action plan which has I think, investment, a key component. The objective is to lift collective GDP by 2% above the trajectory implied by the current policies.

We are now, together with the OECD, with the IMF, trying to push countries into more action to achieve the objective of the 2% and what is going to come out from the Brisbane summit is an action plan which we are pushing for making it a bit—to making it considerably stronger than what was decided last year in St. Petersburg and trying to offer also the example of the coordination of civilians that we have in Europe to make sure that it is not simply a bottom up of a number of announcements which are forgotten as soon as they are pronounced, but there is—but we put in place a system of peer review and a monitoring device which monitors indeed what member states and G20 members will do in the next year very much pushed by the Australian President also the creation of global infrastructure center which is being discussed at this very moment.

I think this is the whole picture. As you can see, the angle of investment is taken and I think it is the right way of looking at it, taken in order to broaden the policy agenda and to see this as a trigger for prompting the right macroeconomic policy stance, the right micro and structural reform stance. I think it would be problematic if we just look at investment by selecting one specific angle instead of having this comprehensive view. And through this comprehensive view clearly you will get also the growth model that will have to be fundamentally reshaped in Europe if Europe wants to prosper and get out of the hole in which we are at the moment. Thank you very much.

Adam Posen: Thank you so much, Marco. And I want to commend you and your colleagues in DG ECFIN, because the genuine intellectual shift that you made oblique reference to, not just about demand but about the importance of public investment, the differentiation of different forms of investment and spending and I think perhaps as critically, the shift to thinking about structural reform as not being just labor markets in the stressed countries, but product markets throughout Europe. I think these are things that obviously you and your colleagues have been building towards and I commend you for moving the debate in that direction.

We have a very good audience. I want to turn it over to them for questions since you do end up giving us generously a bit of time, But let me just ask one question to get us started.

When we look around the world right now, so I'm now going to go very much opposite to where I think you're going and where I personally am, but just for the sake of argument, when we look around the world right now corporate fixed investment is down everywhere. Dave Stockton gave his analysis and forecast for the US economy, for us last week and we stressed the fact that we're still waiting for corporate investment to rebound in the US as well. It's very easy to explain why public investment went down in recent years but once we get beyond say 2010, 2011 it's less easy and evident to say why corporate investment has been unresponsive to easy monetary conditions, low asset prices and so on, especially since the US and UK, for example, also have companies sitting on huge piles of cash.

Just analytically, how do you think about this? I mean, if we take what you're recommending it seems to be addressing the structural failures in the capital markets in Europe, which, I think, is a perfectly sensible thing to do, but that doesn't explain why we've seen outside of the Euro area and around the world the paucity of private investment. How do you think about?

Marco Buti: I think first of all, let me thank you, Adam, and the Institute, Moody's also for the [inaudible 00:34:20], for the continuous intellectual stimulus that you have provided also in a very critical way which is the name of the game and I always use you as the levers to convince my political authorities. So I think this—I'm counting that will definitely continue in the future.

I think it is true that and I mentioned en passant, when I presented my slides, when you compare the investment performance in Europe with that of the US I qualified—I mean, the benchmark has not been an extremely buoyant one so that we are—so there isn't an issue I think overall. I think if one takes an equilibrium view of investment, we have done these analysis ourselves, and if you project lower growth in the future then you can also have the equilibrium investment which is lower now.

I mean, actually there are some analysts you take, I think Daniel Gross has come forward with a recent piece, who actually argue that in light of this there is not much of an investment gap in this. So this element here I think has to be taken into account so the equilibrium investment. It does not mean that the equilibrium investment is a desirable level of investment, because I mean, that would imply accepting that you go down to shift to a lower trend growth that this would be something that is accepted why it is not accepted in the light of what we have.

I think a number of elements which affects here, I use the uncertainty indicator but one can break it down in a more explicit manner, but even lately take for a number of countries in Europe, I mean, the impact of the geopolitical crisis, the uncertainty in Ukraine, et cetera, it's pretty evident in those conditions that the situation is not conducive to higher investment.

There is also an issue and I think on this I think more work will be needed and I would welcome very much input on this, clearly different countries both for private as well as for public investment managed to extract more growth out of a certain level of investment than other countries. I mean, I mentioned the world economic outlook and talk about public investment, let's say the self-financing investment that you have is in the optimal situation in which you have no waste.

If you go to instead investment, which is less profitable, clearly you have much less of an effect. I think the same applies and I think even more in a more pronounced way for private investment. And you can see for instance, you take Germany in Europe, it does not have traditionally a high investment ratio but it manages to, let's say to make most of it much more than other countries with higher investment rates. And what I think is my final word, what you have there also is the issue of reviewing the investment strategy in the light of the global production chains, which imply that you not necessarily invest in your country for Germany typically but you invest very much abroad.

Then the question would be how to make investment in Europe more profitable and what are the conditions in order to trigger that? And maybe a number of policy avenues that have depicted could help in that front.

Adam Posen: Great, very thoughtful. Just picking up on your mention of Germany for a moment and you had said in your slides about the idea of those countries having room to increase investment doing so, public especially. Just could you say a word about how the fiscal compact and the surveillance has currently constructed and reconstructed in Europe will push some of those countries to take up expansionary policies or not? I mean, as you're well aware, people in this building but elsewhere have always worried about this being an asymmetric fiscal compact and I was wondering your thoughts on that.

Marco Buti: I was expecting something of that sort.

Adam Posen: Of course.

Marco Buti: Now, what we have in Europe are rules, let's put it like that. There are rules of a proscribing nature, not of a prescribing one. So the logic of the master treaty, which has then been embodied in the stability pact, is what the treaty says avoid gross errors. And there, the frame of mind that the fathers of the treaty had reflecting also the economic thinking and literature at the time, was that when you move to a monetary union you have a natural deficit bias. So they wanted to rein in these temptations for excessive accumulation of debt and high deficit. So they proscribed a number of behaviors; they did not prescribe.

Now we have made some steps in the direction of a more prescribing nature of fiscal rules by the kind of country-specific recommendations, which I briefly talked about there. But it clear that the country-specific recommendations have—they are more of a soft coordination sort rather than the hard ones, which are embodied in the fiscal compact and in the excessive deficit procedure.

Now what we can see for—and this is the case in a number of surplus countries, it's more on the power of, let's say, persuasion and let's say, talking about the political economy of this and I would see a link between, let's say, the kind of structural reforms strategy that are badly needed in the case of Italy and France to boost competitiveness and productivity and the kind of accompanying role that a stronger demand in Germany would have.

One could look at in the case of a number of surplus countries, is kind of room for maneuver they have under the fiscal compact and under their own domestic rules because take in the case of Germany, they have to abide to the European rules, the fiscal compact, six-pack and two-pack, so the stability in the growth pack in Europe. And then they have also some rules at the constitutional level with a debt break. And so one should look at what extent—there is room for maneuver let's say without violating-necessarily violating the self-chosen rules. We consider that in the present juncture in light of the need to invigorate the demand in Europe there should be more action on that front.

Adam Posen: Brilliant, thank you. Let me open it up for questions. Just to recap for people, we have a moving mic up front thanks to Jessica. We have a standing mic at back. I'll recognize you. When I do please state your name and affiliation so we know who's speaking, but first let me go to our co-host.

Male Speaker: Thank for that, Adam. Let me just start by thanking Marco for kindly accepting the invitation for the event.

Marco, if I can go back to the questions that we just addressed concerning the investment, global investment et cetera, I do think that the question that Adam just posed, which effectively, if we seem to have a glut of savings at the private sector at a global level half of the factors that you mentioned that may be seen as global but the bulk of the unaffected are European ones, they do not really serve as an explanation why do we have this apparent glut of unused investment sources in the private sector in the United States and in Japan. This for me is still very much an open question. You can make the case that you have expectation of questions that are global related to how the global economy is going to be performing in the future but this then deserves a more global explanation than the European specific factors that you just mentioned.

On the questions of investment and investment in infrastructure. [Inaudible 00:44:06] a certain note of perhaps warranted skepticism here. I as a proud Portuguese citizen, right, I come from a country that you can make the case that didn't have the same sort of a real estate bubble that arguably we had in Spain but I think that you can make a case that we had a public investment infrastructure bubble. We are a country that has a higher number of kilometers of highways per capita now than in Germany, right? When I was born there was only one highway in Portugal so you can imagine the implication of this increase.

Now as you pointed out, the FX between growth and investment are not necessarily linear. Germany seems to have a very large amount to derive a greater assistive growth from the existing stock of public infrastructure. So just by assuming that we are going to increase investment in infrastructure doesn't necessarily imply that we're going to have the growth effects that one might expect. Also when you frame the argument that certain member states may increase the investment, we're effectively framing. That's not only in terms of Germany would need debt, but in terms of the knock on effects in terms of the periphery, which is a different story, right. The Germans could still have a reasonably sustainable medium term growth path if they are current stock of the investment and investment in infrastructure. If we are framing the question in terms of the supply push that this is going to have for the periphery,

Adam Posen: It's up to you. Do you want to respond to that?

Marco Buti: Yeah, maybe let's take another couple of—yeah.

Adam Posen: That's fine. So great, so Jacob, could I ask the lady in back to go to the standing mic? Thank you.

Jacob Kirkegaard: Jacob Kirkegaard from the Peterson Institute. I was wondering Marco, if you could walk us through your views in the political economy of structural reforms in Europe because it seems to me that that's sort of the heart of also generating a broader climate that's conducive of private investment. You mentioned that seemingly countries that have their countries against the wall that are on the program seem to do more reforms than countries that are not.

Now the immediate policy implications of that would be that actually, if you're the central bank you conduct a monetary policy that is perhaps too tight and if you are the fiscal surveillance authorities, AKA the commission, you actually do not give countries additional fiscal space. And the idea that somehow that is articulate in some of the policy advice from other institutions of this nature, that somehow you can bribe countries to do structural reforms by giving them additional fiscal space is actually pushing in the wrong direction. Is that how you think about it or how should we interpret the recent moves by the commission on this issue?

Adam Posen: It’s up to you. We can take one more question before-

Marco Buti: Let me take this too. First of all, I think the points that I made before on the quality of investment is absolutely key. And I have to say, I fully agree with you on the fact that in Europe, in Southern Europe, you mentioned Portugal, but you can take Spain also and you try to assess there let’s say the amount and density of infrastructure compared to other things, I mean, it’s probably over the top on a reasonable equilibrium.

So I think this is a good point and that’s why also we are trying to struggle and I would say we've certain difficulties in the context of the G20, so they're meeting just a few blocks away, on the fact that we should look at the investment not only from the point of view of an infrastructure and material investment also but the immaterial ones. So the investment in, let’s say, human resources, R&D et cetera, being as important.

Obviously there is a lot of push back there because the emerging economies said they won’t put much more emphasis on material investment in Australia as well as the chair of the G20. So I think this element here is important. So we’ll need, when designing the Juncker package, which will come as I indicated in November, December, we’ll need to pay due attention to this element as well.

It has, I think, an important consideration also as a qualification of the point that I made at the very beginning of, let’s say, investment being helpful when it’s done both on the supply side and on the demand side. Clearly if one has more of a concern about the demand side then you may want to do more on the material investment, which is I think it has a higher multiplier in the short term.

If you think more about these, let’s say, supply side considerations and link with you know total factor productivity, you may want, by pushing the frontier, work more on the immaterial investment side. So I think this is I think the one we have to take into account but I think your point is well taken.

Now on the political economy of structure reforms. I think here I mean, there are two views on the literature. I have written myself also some in the past both on the theory and the empirical evidence on structural reforms. There are two views basically. One is that when you're thinking about structural reforms and let's say, fiscal discipline, there are those who emphasize the substitutability between the two and those who emphasize the complementarity between the two.

I mean, basically the substitutability is that if you give a bit more leeway then this leeway can be used in order to compensate the losers which we know are there in the short term for certain types of structural reforms, so you give incentives to more structural reforms. This is substitutability view.

In the complementarity view is that look, you are—it's only when you have indeed you are pushed and you are stirring to the abyss that you decide, you find the political courage to do the structural reforms. In this case here, being against the—shoulder against the wall, it would help to trigger the structural reforms given the hardship.

Now the theoretical analysis and the empirical with pre-crisis with evidence that we found in this paper was that a key element which plays in determining whether the complementarity of substitutability story holds, is the time horizon for governments. So for those governments which have a longer time horizon then the substitutability story, I think, plays more. For governments which are myopic and there we measure it by distance to the next elections, I think the complementarity story, I think. And I think this is by and large, it makes sense.

Now the question is that what happens during the crisis and what is the evidence there? The evidence is definite. Complementarity wins and it is shown by the graphs I mentioned before. I mean, the reforms are done only in the hardship, either because of financial market pressure or because there is a helping hand by the IMF and the EU pushing the countries to do so by more stringent monitoring.

Now I think if one looks to the future there is the debate on the flexibility of the stability pact and how to—we think the existing rules having some more room for maneuver would be to establish, let's say, a monitoring system, a commitment technology which would allow by—let's say, to revert more on to the substitutability element whilst preserving the key rules of the stability pact because they don't want to change the rules again.

Clearly Germany is skeptical about this and I think the examples that they have in mind are essentially too and I think they are well taken. One is summer 2011, Italy, Berlusconi's government and a lounge of the S&P

program by the ECB. Commitments up front by the government at the time, ECB starts to buy Italian bonds, commitments, put in the drawer and forgotten.

The other more recent example, let's say the two additional years given to France basically last year, 18 months ago, commitments to use these two years to accelerate on the structural reforms, the first reform that came through was on the pension side and let's say, it was half baked at best and we know and the French government also acknowledges at the time. I'll have to go back to the pension reform.

So I think looking forward, since we do not want to have a masochistic approach and try to put countries in trouble to make sure that they reform, we will need to have a clear agreement, a clear political commitment, to make sure that the reforms are implemented. In the pact, there are a specific clause which for countries not in excessive deficit. You can have some leeway for structural reforms but we insist very much on structural reforms being adopted, not just vaguely announced to make sure that this commitment sticks.

Adam Posen: Terrific. I will resist the urge to go deeper, just commend you on the blending of research and experience and we'll look forward to debating that in the future. Please, if you could go to the mic at back.

Roumeen Islam: Thank you, Mr. Buti for your very informative speech. I'm from the World Bank.

Adam Posen: What's your name, please?

Roumeen Islam: Roumeen Islam.

Adam Posen: Thank you.

Roumeen Islam: So you listed a number of factors that are affecting investment rates and I was wondering whether you could talk a little bit about different types of countries because they vary a lot, particularly if I look at some of the emerging economies, they vary a lot in terms of what might be the most important factors in these countries. For example you mentioned decline in public investment rates which differ across countries. You mentioned the financial fragmentation which one of the results of which is SMEs not getting credit. So if you could talk a little bit about perhaps country typology, that would be very interesting. Thank you.

Adam Posen: Do we want to take one more question? Yeah, the gentleman there.

Arturo Porzecanski: Good morning. I'm Arturo Porzecanski with American University. I gather that the commission and France don't see exactly eye-to-eye with regard to fiscal policy and so I was wondering for those of us who are not insiders like you are, what has changed would you say for the better, for the worse or not at all between the commission and individual countries, especially those of significance, with regard to the analysis of fiscal policy and measures to implement some kind of discipline before 08 and now, let's say.

Adam Posen: Thank you. Before Marco responds, I just want to say those will have to be the last questions. As you can see not just from the two badges that he's wearing, but from his intellectual engagement, he truly is at the center of the public discussion right now and he's been very generous to give us the time he has. So Marco …

Marco Buti: Yeah, I think two not very easy questions. I think if we take the five elements that I have listed in my slide from the accelerate to the deleveraging needs, the financial fragmentation, the public investment reduction and uncertainty, I think you can quite easily map it out to a different situation of the countries. I don't exercise essentially from Europe in my own backyard, but maybe one could apply that also more globally.

It is clear, for instance, that when you come to financial fragmentation the countries which you can see in the chart, having quite considerably higher interest rate and less favorable lending conditions, more affected by that. When you come to the impact of uncertainty, I have to say I've written myself on this and had a little bit of controversy with some criticism on the relation between uncertainty and investment but I think one can be pretty safe in concluding that if you take uncertainty in the midst of the crisis when the Euro area faced existential threats, I think there is no doubt that if you do not know the next day in what currency you are going to be repaid you don't have much incentives in doing investment there.

And I think on the accelerator thing, I think this is pretty uniform across Europe considering how domestic demand has slumped maybe in differentiated ways. So I think this mapping can be done and one can attribute, let's say, the relative weight to this and possibly other reasons.

On the view on fiscal policy, I think one can go back to what I indicated before, namely the prescribing versus proscribing rules. I think the current set of rules that we have which is of the proscribing in nature, I think works well in—has a chance to work well in more normal times. When you come to crisis times in which you would need also a bit more active policy, I think it has to be complemented by some more, let's say forceful recommendation, also for countries which have, let's say, the fiscal space.

What we are witnessing a bit in Europe is that there is in a sense, less willingness to use the fiscal space for countries which have it and countries which do not have fiscal space they want to use it but they don't have it. So I think the discussion on that front will, I think continue in the next weeks. I see also as a way forward here a strong support for robust and credible package at the European level so what comes out from the Juncker commission in the next weeks will be important because doing things collectively at the European level also allows to, let's say, to find some space which the member states individually cannot be found.

Adam Posen: Well, thank you so much, Marco. As always, you're not only gracious, but you're so deeply engaged at all levels and it is always a privilege for us to interact with your colleagues at ECFIN but in particular to have you come and interact so deeply with our audience so frankly and so thoughtfully.

If I may, I'd just like to say we thank you for your extraordinary service over the last six years to Europe and to the world and we wish you and your colleagues the best with the Juncker investment package and we will be very glad to be critical or complementary as the cards fall but we wish you the best of success with this leadership effort. Thank you very much.