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

Session 2: Beyond euro area programs: adjustment anchors and fiscal frameworks in the EA

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Lúcio Vinhas de Souza: All of you please; we are promptly starting with the following session. I would like to take the opportunity to introduce the first one of our speakers, Ayhan Kose, the current Director of the Development Prospects Group of the World Bank and an old friend. We actually participated in a series of activities a good 15 years ago. And when you start remembering the things that you did and the things that you wrote 15 years ago, this tends to be a bad sign, age-wise, I mean. Ayhan, please, the floor is yours.

Ayhan Kose: Thanks. Thanks for inviting me. Lúcio gave me a tough job actually. I need to do a number of things in a very short time period. I need to talk about global prospects, Euro area prospects, and then talk about the evolution of policies in the Euro area and then talk about what other crises can be as examples or lessons for the Euro area. I'm going to do that very quickly.

I try to avoid actually, giving presentations about the Euro area because I feel that whenever I talk, I state the obvious. Now, I'm going to do the same. I think that I'm going to state the obvious, but hopefully it's going to be with some insights, some insights. So I'm going to ask four questions and I will answer these very quickly.

So the first question is what is the global economic outlook? Slow recovery in the baseline but downside risks dominate. I will explain. You have been hearing it this week, but this might be interesting.

What's the outlook for advanced countries and the Euro area? Diverging growth trends. I will explain what this means. In the Euro area though, the weak growth, low inflation, and high unemployment.

Third question, how have Euro area policies evolved recently? Of course, you need to have a reference point. The reference point is compared to previous global recoveries. The answer is very decisive there. In previous global recoveries in the Euro area you had monetary and fiscal policies aligned. In the latest recovery you have this great divergence of policies.

And finally, what lessons can the Euro area draw from other crises countries? There are two important lessons, focused on growth through structural reforms. The second important lesson maintain flexible and credible. This is just not the flexible and credible fiscal policies and recognize their problems.

Now, the first question, what is the global outlook? Slow recovery in the baseline, but downside is dominating. This graph is a very simple graph. The blue bars are the important ones and the important here, how the global growth has changed since 2010. Every year global growth declined relative to the previous year, 2011, 2012, 2013. In 2014 we think that there is going to be slight pickup. In 2015 growth is going to come back to a level somewhat more satisfactory. So this is the first observation, slow recovery.

Now, there are many downside risks and those risks are dominating this baseline. I'm not going to get into the details of those downside risks. The normalization of monetary policy was always a downside risk, but increasingly divergence of monetary policy is a downside risk. Financial access is another one. Geopolitical risks, we saw the early slowdown in China. You name it.

But now, what is the most interesting is that how we have been making systematic mistakes in our growth forecast over the past three years. And it's very important because as much as I told you that there is a slow recovery and there is going to be a pickup in growth, I'm not entirely sure that will happen.

This graph shows you how our forecast evolved over time for the past three years, 2012, 2013, and 2014. So in each year we started with a higher growth rate. In the previous year, for the next year, this yellow line shows you that June 2011 for 2012 and the June 2012 for 2013 forecast and the June 2013 for the 2014 forecast.

And now what happened? Gradually, we reduced our forecast and this is the latest forecast. So in each year we systematically are over optimistic about the state of the global economy and then we downgrade our forecast.

So now, let me turn to the second question. What's the outlook for high-income countries and Euro area? There are two important observations. One, diverging growth trends. Whether this is good or bad the judge is out there, because it will create all types of policy issues and they will create all types of repercussions for financial markets. Now, but for the Euro area there is excessive certainty. Unlike Marco Buti talked about the role of uncertainty, I feel that the big problem with Euro area prospects is that excessive certainty and I will explain what I mean.

Now, this is a graph showing you what was the growth rate, average growth, prior to the crisis 2003 to 2008, that's this yellow middle line there, and then the growth numbers in 2013, 2014, 2015, and 2016. For the US and UK you see that these economies are going back to the growth rates they registered prior to the crisis. For the Euro area and Japan that's not the case. So this divergence in business cycles which we have not seen before easily. We have seen Japan being idiosyncratic but between the US and Euro area we have not seen it yet. That's going to create challenges.

But now, the big issue is that how our forecasts with respect to Euro area have evolved over time. It's the same graph I showed before, the global forecast for the Euro area. What happened is that in 2012 and 2013 we were optimistic. We systematically over predicted to grow performance and then the Euro area disappointed us. In 2014 actually, it did not. So in a sense markets converge dispute this view that Euro area growth is going to be low and Euro area delivered that. That is important.

Now, going forward, what are the market expectations about the Euro area activity? For that I'm going to show you this graph. It's a very simple graph. It shows you that dispersion in forecast in growth, US and then to [inaudible 06:39], Germany, France, and Italy and on the right, Euro area. Here, don't worry about the numbers. Numbers are low, but look at the dispersion. Dispersion is quite tight as well. So that many forecasters out there are optimistic about growth in the Euro area.

What about inflation? With inflation people's expectations are actually inflation numbers are going to be low. They are not expecting inflation in 2015. Actually, the highest number is around 1%. That's half of the ECB's target.

What about unemployment, which is I think the most striking one? Forecasters are not expecting unemployment rate is going to go down in the Euro area in any meaningful fashion, whether you look at the most optimistic one or the mean one. So for the Euro area there is excessive certainty about weak activity and that asks you what types of policies are necessary?

Now, I'm going to summarize the evolution of policies in the Euro area with a very simple graph. And then I will talk a little bit about effectiveness of these policies.

So the question is how this Euro area policy evolved. In the latest episode in the latest recovery compared with these previous global recoveries, and these previous global recoveries refer to the three episodes, 1975, 1982, and 1991. So I'm going to compare the evolution of policies with these previous episodes with the latest one.

This graph is very telling. It tells you that in previous episodes policies in the Euro area, fiscal policies were decisively expansionary. In the latest one it was decisively contractionary. It's now neutral. It's now neutral. The big problem is that now you have a deep recession and the expectations about growth very dismal, contractionary policies have the largest harmful impact. Fiscal policy is very effective during recessions than it is contractionary.

Now, what about monetary policies? Monetary policy is just the interest rates. We know where they are. And market's expectations are that interest rates are going to be low in the Euro area for the foreseeable future, even if you go November 2018. Look at market expectations. They expect very low interest rates in the Euro area.

The big problem is that you can look at the balance sheet of the ECB. You will see the same. They're actually trying to expand the balance sheet. As much as you implement more aggressive policies, the effectiveness of the policy gets diminished. So, on the one hand you have very effective fiscal policies dragging down the economy. On the other hand you have very aggressive monetary policies, but its marginal impact increasingly limited.

Now, let me turn to my last question. This is specifically Lúcio asked me to look at. There's a growing industry comparing the Euro area episode with the previous crisis. And there are very interesting lessons we can learn from those. But at the end of the day, these lessons again, it's like stating the obvious, but I will do that anyway.

So the first lesson I think, we need to focus on growth through structural reforms. The second one, maintain flexible policies. I could just stop there. Just say flexible but that's not enough because that flexible refers to a part of your area. There's this other part and a very important part that demands credibility. So the flexible and credible policies I thought may be a good way to summarize and to recognize their issues.

Now where do we learn these lessons from? The first one is the main lesson coming, the Asian crisis. Now, Asian crisis there were some reforms implemented and those reforms delivered positive results. Of course, there is a very interesting example, the example of Japan. And people ask this question, whether Euro area is becoming like Japan increasingly?

The very interesting paper, Hoshi and Kashyap, wrote last year for the IMF Annual Research Conference, it will be in the IMF Economic Review soon. And in conclusion, it's very telling. Many of Euro area countries also face some of the same structural impediments to growth in Japan. Without drastic changes, they—France, Italy, and Spain in this case—are likely to follow Japan's path to long economic stagnation. And I showed you the prospects, and those prospects actually, if you discussed it through stagnation that stagnation has already arrived to Europe.

Second, fiscal policy should be sufficiently flexible and credible to respond to changing circumstances. I think this is the discussion of the day. And actually the lesson from the literature is very clear. Again, these are very recent papers. The very interesting paper by Anusha Chari and Peter Henry, they look at the Asian crisis.

In the context of Asian crisis there's a presumption that this crisis countries implemented contractionary fiscal policies. Their finding is that no, in fact, whatever contraction was there it was at the beginning of the crisis. They turned to expansion of policies very quickly and then they looked at the European case and their conclusion is that the fiscal policies implemented in Europe was harmful for the recovery.

Now, another example is Latin America. And there the issue is the push for consolidation for an extended period of time during the Latin American debt crisis and the severe consequences for that in the last decade. When you think about the experience of Europe, Europe is almost there. Its five years' recovery and I think that Marco's presentation was telling in that regard.

And the third one, the importance of recognizing debt problems and avoiding buildup of risks. And there the example is very clear. In Latin America you can delay the inevitable, but sooner or later you need to take the pill and accept the losses and then move forward. Asian countries, they restructured the banks quickly, the corporate, and then the example of Japan postponing the structural solutions with respect to financial sector issues.

So I think I covered a lot. In one respect I did what I was thinking of going to do stating the obvious. These four questions are questions of our times. And for the Euro area, I think the prospects as much as they are bleak; the good news is that policymakers are very much aware of these problems and the hope is that they will do the right thing.

Lúcio Vinhas de Souza: Thanks very much, Ayhan, among one of the reasons is because you ended precisely on time beyond having very challenging analytical questions for us. I would like to ask Rolf to come to the podium.

Rolf Strauch: Thank you very much also for inviting me here. In reading the title of the panel, I mean for me coming from a crisis resolution mechanism, it essentially means to answer the questions whether we are better prepared now to cope with the upcoming challenges over the next years and in the long run with any huge crises than we were a couple of years ago. And in my short intervention I would like to give an answer to that. And from my perspective it clearly goes to the affirmative. I think we are better prepared now for different reasons.

We all know that the crisis had various sources. One source was that national policies were not geared towards monetary union hence, the emergence of big imbalances, different macroeconomic fiscal imbalances. Second weakness that was apparent is market failure. There was an underpricing of risks. There were misperceptions that contributed to the crisis and one had to work on that in making the financial system more secure. The third weakness was institutional gaps that emerged when you actually went into trouble and you didn't have the means to address them.

Now from my perspective, in the course of the crisis, actually these elements have been addressed and I think we have advanced very much on three fronts. What present here and what is a major component, in here mainly in the area of crisis prevention in addressing problems, is evidently the fiscal and macroeconomic framework, the strengthening of the framework that was achieved over the crisis.

And here again, I feel like Vitor before a little bit like me being the priest and talking about the *Bible* while the pope is in the room [inaudible 00:15:37] knows it all. And let me here be very—that's also in a way very general and highlight the three points that I see where the achievements were made.

So the first main achievement is in the strengthening of the rules that relates to—and that is what you mentioned just credibility. It relates among others, to an improved and strengthened focus on debt as compared to deficits only or mainly deficit focused. It relates to better monitoring possibilities, also through stronger Eurostat information gathering options and it relates to decision-making processes, which give in a way, more automatism much more power to the European Commission in steering the process, so procedural strengthening. So overall, we work towards credibility. At the same time, flexibility is not lost. By looking at structural balances, structural factors, by giving flexibility on timing in terms of adjustment, there's still a flexibility element in there, so first point, strengthening of rules.

Second point that comes that is very important forward looking, is we move from a system of exposed sanctioning to structure of ex ante coordination. That's I think a core piece of what was achieved and what is kind of enshrining the overall schedule that keeps the Commission colleagues busy throughout the year in reviewing and getting budgetary plans as they're now supposed to come in and looking at them and giving countries specific recommendations to have a followup systematically, so a higher degree of coordination before, so to speak, things can go wrong.

The third element that I think is crucial in terms of the overall strengthening is that the weakness that came from a lack of monitoring of macroeconomic imbalances together was filled. So there is now an imbalance procedure that looks at it. The pure focus before was on fiscal. There was no tool developed to look at current accounts. That has now been cured, and it's monitored and the Commission has also—even the initiative, the possibility of taking the initiative of asking for fines. That I think, is one important piece.

The second element what I said is institutional gaps. And here we come to our own institution because once it had happened what was supposedly never to happen, you feel that you needed something to resolve a crisis. So the ESM was created after temporary arrangements with the EFSF as a prominent crisis resolution mechanism.

For me here it's more than just like the money that we have given over the crisis that matters or kind of the residual gunpowder that we still have if you wish, so the unused the capacity. It's how the different elements fit together and how we operate. And again, I would like to make three points on that.

I think what is most important is that it's the framework in which we operate. It's crucial because we give financial assistance under an IMF-type approach when there are structural reforms. This is liquidity support while you need to reform in order to get on a healthy path. And we do this under the condition of debt sustainability. I know that there are some questions around that. I mean a lot of people here in the room will probably think about Greece. But if you think about Greece, if you think about Cyprus, you also see that before we came in, based also on the advice of the IMF or in collaboration with the IMF, there was debt restructuring before. There was the participation of the private sectors. So it's not an empty shell that when it's said that that's sustainability as a crucial factor in order to make it work.

There were also quite some doubts on whether the policy conditionality would work and there are still voices that say it's all not functioning. But again, if we look at what actually happened and unfortunately Alessandro has left, but the Lisbon Council is one of the institutions and the OECD is one of the institutions that published actually reports that showed that the program countries are the reform champions of the OECD. They are the top reformers in the OECD, coming maybe from a relatively low level or from a difficult state of affairs. But tremendous efforts were done. And the questions or the doubts that you can have such a framework in the Euro area among advanced economies doesn't show to be warranted. So I think that's very important the framework works.

Second point, the terms at which we provide support are beneficial to render a sustainability of debt. And here I come also to the Greek point, to there's a lot of focus on the debt level, debt-to-GDP ratio. We are the biggest creditor of Greece, 45% of Greek debt is for EFSF, but the terms at which they are given are super favorable, if you wish, and support that sustainability. Average maturity, maximum maturity is 32-years. We have a 10-year interest rate deferral. We have at the moment interest rates of 1.5%.

From that perspective, there is no debt overhang for the next 10 years and investors know that. So I think what is important is that the approach that we have chosen is different from the IMF for good reasons also, because the IMF would never come in in a country that's 45%--taking up 45% of its debt. But it brings us a lot of support. It brings us a lot of sustainability, given the financial terms.

The third element that the toolbox that we have is efficient and it helps to keep countries in the market. This relates to the condition credit lines that we can give to the primary market purchases, which are instruments and the indirect bank recapitalization, which are instruments in a sense to try to make our efforts efficient.

And sometimes their questions, well, or it was said even here by one participant, you're a good for the small cases, but when the real problem comes you can't help. I would not agree to this. I would not agree to this because we have the tools for preventing that it goes into the very worse situation, that a country has fully cut off the market and then 450 billion is a lot of gunpowder to support. That point I wanted to make on the second element, which is the institutional gap that was closed through us a crisis resolution mechanism.

The final point and here it can be rather short because you have discussed this amply this morning, I understand, it is banking union. And clearly in order to address that market failures and the consequences of market failures can occur again, crisis prevention in terms of preparedness, in terms of strengthening the institutions, in removing the weaknesses of national supervisors, crisis resolution in terms of de-linking sovereigns and banks. The approach had shifted from bailing out at the European level to bailing in of creditors. That was the paradigm shift that came over the negotiations and is now implemented.

And against that background I could not follow the entire discussion, but I've heard about the question of common backstop. How big is the backstop, is it enough? The seriousness of the bail in has to be really taken into account for the overall framework. And we have looked at the experience from the crisis ex-post. If the bail in rules under the BRRD were applied you can go very, very far in addressing the consequences without having to involve public money. So from that perspective also the amounts that are now put on the table don't look as small anymore. And I think one can claim that there's some efficiency in here.

I think from that perspective, looking now backward, we are better off. And looking forward I think one can also say that we are better prepared for any problems that may come along both in terms of crisis prevention and in ability to resolve crisis. Thank you.

Lúcio Vinhas de Souza: Thank you very much for that, Rolf. It was very clear presentation that highlights the value of the same as British in the institutional gap. Now, the Paolo Mauro will deliver a presentation.

Paolo Mauro: Thank you very much, Lúcio. I'm going to begin by putting up on the screen some charts, which shouldn't look too unfamiliar to you. You probably have seen something like this before. But my objective is to have a subliminal message in front of you while I deliver my remarks.

And what I'm showing on the screen here is straight out of the most recent World Economic Outlook. It's the level of real GDP for the United States set at 100 in the year 2007. And we see the Great Recession but things look like they're going back to normal. The situation is very different in the European area. In the Euro Zone, what I want to emphasize is that the level of real GDP in 2015 is projected to be approximately the same as in 2007, 2008.

Within the Euro zone there's tremendous variation and I've spent quite a bit of time staring at 20 plus charts for each of the countries. I'm not going to inflict that on you, but I'll pick two extreme cases from the large economies. And here is the case of Germany, which is doing relatively well, but still the recovery is pretty uncertain. And I believe the exact forecast for 2015 is 1.5% growth. I think that forecast is already out of date. And I think you will hear the forecasters making statements like there are lot of downside risks and I think that's for sure.

The situation is very different in the case of Italy where you really see a tragedy of the level of GDP in 2015 being projected to be a little below the level in 2001. So I think it's important that as discuss fiscal policy, we keep those at the back of our minds. And it's clear that the objective for Europe is to raise growth, to raise employment, particularly for the youth, while not sowing the seeds for another crisis because that would undermine the initial objectives that we're starting from. So what can we do with fiscal policy?

I think fiscal policy here can do a small amount. It can do a little bit, but it can't do very much. It certainly cannot do as much as monetary policy, which should stay accommodative. In fact, it should become even more accommodative. Fiscal policy cannot do as much as structural reforms, which are clearly needed. But obviously, our task today is to talk about fiscal policy. So let me speak a little bit to the small amounts that can be done through fiscal policy, distinguishing between the near-term, the reforms that can take a few years to undertake regarding the composition of revenues and the composition of expenditures and then very briefly talk about the vision thing for Europe.

So in the near term, most Euro area economies have their hands tied. And they have their hands tied not so much because of the Growth and Stability Pact, not so much because of the European Commission, but because of a much more powerful force, which is that of financial markets.

And in fact, I view in this context the Stability and Growth Pact and the associated EU architecture as very beneficial. The fact that countries have to go to the EU Commission and present their three-year fiscal plans gives clarity and gives reassurance to the markets. So calling into question the agreed EU architecture with generic calls for flexibility, I think can be extremely harmful. And markets can react. They can react abruptly, unexpectedly and they can impose even stronger discipline on countries' fiscal policies.

So is there a case to make the EU rules less stringent? I think unambiguously the answer is no. A campaign to loosen the rules would backfire. And here, remember, the optics are as important as the substance. If you have an overt and loud debate among politicians of different EU countries then the international media is going to portray that through [inaudible 00:29:05] stereotypes and markets will react.

In particular, the 3% deficit limit, which is just about the only thing that the general public understands, is something that should remain sacrosanct. It has to be in place. And if we start tinkering with the recently approved constitutional amendments that enshrined structural balance into national law that again, would weaken credibility. Besides changing the fiscal rules, adapting them, making them more flexible at this point, the fiscal rules are already very complicated in Europe and very hard to understand for the general public.

Now, we are reaping tremendous benefits right now to take an extreme case again, that of Italy. In 2015, the equivalent amount of a little more than a quarter of GDP will be rolled over in new sovereign bonds. And the same would be true in 2016. And the amounts are large also in Spain and Portugal. So we are reaping tremendous benefits from low interest rates and we should preserve that.

Now in a few countries in the Euro area, the position is much more enviable. And a few countries have plenty of credibility, the largest being Germany, where interest rates are below 1% in nominal terms at the 10-year horizon. So Germany has a balanced budget. It has a structural balanced budget. And with its current fiscal plans, it's projected to have a debt ratio of 60% by 2019.

So the objective for Germany should be to secure a lasting domestic recovery and it should be also to be a leader and to show commitment to the European enterprise. The way to do so is to provide a moderate, and I emphasized a moderate, fiscal stimulus. Moderate because we want Germany to remain a bulwark of stability both for its own domestic public f or the Euro zone and for the world. But I think a moderate fiscal stimulus would reduce the risk of prolonged stagnation for Germany and for the Euro zone.

I mentioned there's no need to change the SGP. But there are some improvements that the technical staff of the European Commission can certainly make. I'll give one example, which I think is pretty straightforward. If you look at the way that the potential output growth rate is currently estimated you get the result that Italy's potential output growth is a little bit less than 0. And for Greece, it's negative 1%. Now that has implications because there's an expenditure growth rule which is linked to the estimated potential output growth rate. And we would get to a situation where expenditure growth is constrained unnecessarily beyond what would be reasonable.

Without changing the SGP, also a lot can be done if it's applied in a wise manner. Let me pick another example. The preventive arm of the SGP envisages that countries that have not reached the medium-term objective of structural balance should improve their structural fiscal balance by a minimum of 0.5% of GDP every year. For some countries that's excessively rapid fiscal adjustment. It could be counterproductive. How does one get around that?

Well if necessary, the EU institutions should note that there is a severe economic downturn in the Euro area as a whole. If you read the 115-page vade mecum on the SGP, a severe downturn is specified as negative growth or an accumulated loss of output during a protracted period of very low growth relative to potential. I think that's exactly what the chart shows. So if there's no other way, there's clearly that call that can be made.

Now let me turn very briefly to the composition of revenues and the composition of expenditures, where I think a lot more can be accomplished, even beyond these discussions about austerity versus flexibility. I think, here are two very brief points.

On the revenue side most European countries, in fact most advanced economies over tax labor and under tax property. And I think there is a clear case to reduce taxation on labor, especially for the young. And I think some of the proposals that we heard from the Fiscal Monitor, to reduce social security contributions for the youth make a lot of sense. That would create job creation where it's needed and the elasticity is apparently very high.

On the expenditure side public infrastructure stocks have declined in most European countries. We know that higher infrastructure investment improves potential growth. Beyond that the World Economic Outlook, I think makes a convincing case that the multiplier for infrastructure investment is higher in times of domestic demand that is essentially depressed, which is the case in Europe. And when you're thinking of infrastructure investment, maintenance investment is quick and is always a good place to start.

I would just add that with interest rates being where they are in some countries it clearly does seem to present a very strong case for higher infrastructure spending. And to conclude on a quick point on the vision thing, because I think this is something where European policymakers have been on the defensive for way too long. The media and the market developments have really dictated the rhetoric and the agenda.

I think European policymakers need to regain the initiative and reaffirm their commitment to something like the United States or Europe by the middle of the century. And then they need to spell out some key integration initiatives that will get them to that point. So in the fiscal area there are proposals to issue European bonds. I think those would be credible if they were backed up by a real authority on the part of the EU to collect revenues and real authority to make spending decisions with the approval of the democratically-reelected European Parliament.

Now where would one start? Just an example, the value-added tax would be a very natural place to have a truly common European tax. This would reduce for audit, it would reduce paperwork. It would make the common trade area a real common trade area. So these are examples and maybe none of them are new. But the point is that I think European policymakers need to regain the initiative and to restore confidence and bring back investment in the near term application of the SGP as is, but in a reasonable way, moderate fiscal stimulus by those who can afford it, better composition of revenues and expenditures, and the renewed commitment to a more integrated Europe.

Lúcio Vinhas de Souza: Thanks so much for that, Paolo. It was a great vision ending if you'll allow me to say that. Last but not least I would like to call to the podium my esteemed colleague, Elena Duggar. I should point out if there is any potential acquisition of bias of my choices on this panel is by a pro-IMF, given that most of the people here have formed a connection with the IMF, including Elena.

Elena Duggar: Thank you, Lúcio. Thank you everyone for joining us today. I will take a little bit different focus for my remarks today. And I'll talk about the fiscal pressures that come from population aging. And now again, I'll focus on the European Union. I'll talk a little bit about the unprecedented scale of the demographic transition in Europe, the potentially large impacts that it could have on economic growth and on the fiscal balance sheet and the potential debt sustainability going forward.

The focus on aging today comes from the fact that I'm covering here demographic transition over the next 5-years and over the next 10-years and over the next 15-years. So this is no longer a long-term problem which is out there in the future. And I'll let the pictures speak for themselves. So before I get to the chart my remarks today are drawn from some research. The research is available. If people are interested in more detail, the research is available in Moody's websites and I've given-

Lúcio Vinhas de Souza: And it's actually also printed on the folders that you have in front of you.

Elena Duggar: So they'll be available on the website as well. So here's the map of—this is the European Union. The map shows the share of the elderly population to the total population. It's color-coded based on the UN classification so the UN calls populations between 7 and 14% elderly population is aging so that's the lighter orange shade.

The populations that are between 14 and 20% share of the elderly as aged. This is the darker orange. And then population with more than 20% share of the elderly is super-aged category and this is the red shading on the chart.

So this is the European Union as of 2015. So there will be four super-aged societies in the EU, Finland, Germany, Greece, and Italy. This is the EU as of 2020, so the super-aged societies will increase to 12. And this is the EU in 2025, so the number of super-aged societies will increase to 21, so the vast majority of countries.

From a global perspective, aging demographic transition in Europe is most advanced. So Europe is and will continue to be the grayest region globally. The chart has the old age dependency ratio and the median population age. The blue, line which is the one on top, is Europe.

Something to note here is that the pace of population aging is projected to increase going forward. So the pace not only is Europe sort of the most aged, if you will, but it's also the pace of aging will increase going forward compared to the pace in the past. And this is especially happening over the next two decades.

So here are some of the impacts of that that would have on the economy. So on average across the EU, working-age population growth will fall from the 1.7% over the 15-years to negative 5.5% in the next 15-years. All countries will face either a slower-growing or declining working-age population with corresponding pressure on labor supply. A number of the European countries lead the charts globally so Bulgaria, Germany, and Latvia are some of the countries that will see the largest decline in working-age populations globally.

Aging will also reduce the economy's saving rates, in turn impacting investment. This is an estimate from the academic literature. So the academic literature estimates that 1 percentage point increase in the old-age dependency ratio is associated with something between 0.5% and 1.2% decrease in the average savings rate, so quite large show of sensitivity there.

If you put those two together here's one example of what the impact on the economic growth could be. So the chart here has the Conference Board projections, which use a methodology taking into account—geared towards taking into account precisely the impact of aging. And the estimates suggest that aging can reduce the aggregate annual growth rates in the European Union by as much as 0.6% during the next 5 years and by as much as 0.9% during the 2020-2025 period. Starting from a past annual average growth rate of just 2.1%, the decline is very large.

Of course, policy reforms that improve labor participation rates, that encourage immigration and financial inflows that would potentially finance investment, innovation, and technological progress can now dampen the impact of demographics going forward. Nevertheless, the impact is quite substantial.

And equally large effect, probably in my opinion more challenging, would be the impact on public finances. Just one illustration before I get to the impact on public expenditures, So by 2025 on average across countries, the burden of one 65+ adult in the EU will be carried by just 3.1 working-age adults. This compares to 4.2 in 2010, so again very, very fast demographic transition. The support ratio will be as low as 2.5 in Germany, Italy. Again, this is a problem not only for advanced Europe, but for emerging Europe as well. And a number of emerging European countries will face those pressures at low income levels.

So here's some estimate of what the impact on the public finances could be. So this is based on our expenditure projections. And the numbers I'm quoting are based on France, Germany, and the UK. So with respect to healthcare expenditure if we keep program eligibility, cost, and generosity unchanged, the United States suggest that over the next 40-years, aging alone will require governments to spend an additional 1 to 2% of GDP every year on healthcare.

So if just how we read the numbers, if healthcare expenditure represented 10% of GDP this year, it will be 11 next year, 12% of GDP the year after, 13 the year after; very fast increase. So this is a scenario where cost remained unchanged. If you incorporate increasing healthcare costs, which has been the historical experience, the estimates rise to something like additional between 2 and 4% of GDP annually. This is for healthcare.

For pension expenditure, if we assume constant program benefits, aging will require new pension spending of between 1 and 4% of GDP annually on average over the next 40-years. It is possible to construct the scenario where pension expenditure, so not healthcare but pension expenditures remained constant share of GDP going forward. But that is such a scenario that require a very significant decline in benefits per person.

So this aging pressure comes already in a context where we pension and healthcare expenditure already high in a number for European countries. I think about a third of countries are looking at 20% or more combined pension and healthcare expenditures percent of GDP already. They also claimed in the context where the financial crisis led to large increases in debt levels in a number of countries.

Just in conclusion, I think what I'll point out is we can point to a number of developments that can dampen the impact of aging on the economy, so as I said, the reforms that could improve labor force participation rates. And past experience has shown that labor force participation rates respond to policy changes, raises in the retirement age, immigration flows, financial inflows, and of course, innovation and technological progress. But fiscal challenges are large and they will require rethinking of social programs in a number of countries, in particular problems which were set up in a context of a growing population model.

The historical experience is one—I think that's what I'll conclude with this. The historical experience is one of under-estimation of pension pressures. So if we look at projections of aging a couple of decades back you will see that we've underestimated how fast the transition is going to be. So that's what our forecasts show. So it's a very significant challenge. And I think a number of potential mitigants on the economic side feel so on the fiscal side. I'll stop right there. Thank you.

Lúcio Vinhas de Souza: Thanks so much, Elena. If Paolo ended his presentation with a vision theme with a positive upward momentum your vision theme clearly has a negative downward momentum from the point of view of the Union.

I would like to open for questions from the audience now. And I suggest that we could try to link those discussions that we just had in this extremely rich and extremely analytical powerful set of presentations, to what we had during the day, including mentions about the investment fund of the European Union and the proposal in the upcoming [inaudible 00:45:49] Commission and potential interpretations of alternative takes on that, including statements that were made by members of the Polish government in a much larger set of resources available for investment.

I would like to open to questions. We have a gentlemen back there, please. You can stand in front of the microphone and introduce yourself, please.

Artur Radziwiłł: I'm Artur Radziwiłł. I'm from Ministry of Finance of Poland. So thank you for mentioning the proposal made by our minister. So just I wanted to make two comments. One is on outlook for the Euro area and I would just put it more bluntly what I saw in the slides and what was mentioned by the panelists.

So my assessment of this outlook is that under current economic policies, baseline scenario is the last decade, we are already lived the last decade's scenario and there's a downside risk and that's a risk of the last generation. So this would be an extremely pessimistic view, but I do not believe that the current policy is our baseline policy scenario because attending ECOFIN meetings I see there's a tremendous pressure for doing something to remedy the situation.

And maybe indifference to the discussion that some of the panelists offered here, we see lots of scope for such change. And this is partly explained because I believe there are many assumptions which are not fully justified but sort of limit our imagination what can be done at the European level.

So first assumption is that there's no fiscal space because we have Stability Growth Pact, we have national fiscal rules because of the financial markets. But this is not the case in the proposal program of this Europe Fund of Investment presented by the Polish Minister of Finance, this is proposal, which proposes the 5.5% of GDP of new funds for public investment, is fully in line with SGP rules with the national fiscal rules and there's no sign at all that it could lead to any negative reaction from financial markets. And we've discussed it quiet extensively with the private sector.

The second assumption is that there is some sort of the tradeoff or contradiction between policies that promote aggregate demand and the policies that promote supply and structural reforms. Well there's very clear synergy between the two and it was even made very clear in this recent chapter in the World Economic Outlook, that actually public investment can increase long-term growth rates and they solved short-term demand problem in Europe. Moreover, the big investment program can have structural conditionality built into this. And the third assumption which would stop-

Lúcio Vinhas de Souza: Hopefully, the third assumption will be the last one and then we will have a question.

Arthur Radziwiłł: That would be the last one. The last one is that it's not politically feasible. And here I do not see it happening because as a conclusion to the last ECOFIN meeting, the European Investment Bank was asked together with European Commission to present the list of projects that they were financing at the European level. And there's a special task for it which is working. And even today Mr. [inaudible 00:49:50] said that if these projects proved viable, good, convincing, they would be financed. And he said we would deliver, I promise. So this thing could happen.

Lúcio Vinhas de Souza: Thanks so much for that. I'm not really sure if you're presenting your official position of the upcoming president of the Council or the Union, but in any case. If there are reactions, please let's collect- The lady in front.

Katerina Sokou: Hello, Katerina Sokou, with *Greek Daily Kathimerini*. I would like to focus on the title of the panel, which is Beyond the Euro Area Programs, and ask you about Greece and its indication that it would like to exit early the IMF program. How do you think the markets would react to such and development? And would you think that may be a precautionary program as [inaudible 00:0:55] indicated, that you might be willing to discuss today, could be a way for a smooth transition for Greece? Thank you.

Lúcio Vinhas de Souza: Thanks so much. Let's just get one final question and then try to reply all of them.

Male Speaker: This is a question for Ayhan, because I think this is very interesting where we should have the declines projections year over year, especially in advanced economies. Now, not that I'm actually surprised because when you do forecast with the past you forget that there was very high leverage at this time and that makes a huge difference. This is the Japanese problem.

So my question and my concern and there is some evidence that still leverage had not declined. And still we have a very high leverage, especially in advanced economies, in emerging markets, in advanced economies. Inflation and output growth is not helping to the deliberating process. So perhaps we're entering a long phase of very low growth, especially in advanced economies because of this very high leverage. I don't know what's your view.

Lúcio Vinhas de Souza: I'd like to suggest that we start by Ayhan and then we go to Rolf.

Ayhan Kose: So thank you. The first question, I ended my presentation with saying that policymakers are aware of the problems. I think those policymakers attend the ECOFIN meeting. I did attend it as well in Milan.

The issue at hand of today is there will to implement the policies and come to a realization that maybe for Europe it's a turning point. But we have said this I think multiple times since 2009 and then we are saying it again. Hopefully, the Polish proposal will get traction and will drive some investment.

The second question I won't be able to answer. I'm still an IMF employee at the same time, World Bank employee.

So the third one, the big problem with the forecast is that the issue is not forecasting incorrectly. The issue is that forecasting incorrectly in a systematic fashion because that's not what you want to do. At times you want to move away from that. You don't want to make systematic mistakes.

Of course, high leverage is a problem. But you see in the case of some advanced economies and this is very important for the global economy, it is for the US, there are signs that US is moving to a sustainable recovery. And that's very important because given that emerging economy is slowing down, especially China, Europe is very slow, you have that one engine. So that high leverage problem applies to some economies more than others. And I think that those economies that apply to that problem, given some of them have the problem of deflation, they are going to have even greater challenges going forward and it makes the forecast I think more pessimistic.

But [inaudible 00:54:01] of today I think there are all the signs that policymakers have a good understanding of the problem and very competent governor of the European Central Bank has clear messages on these issues. And until four months ago there was hesitation to acknowledge the deflation problem. Now there's clear acknowledgment of the problem. And the bank is getting ready to aggressively attack that problem and has good proposals on the table on other policies with respect to structural reforms and fiscal issues. But let me stop there.

Lúcio Vinhas de Souza: Thanks for that. Rolf, and of course we welcome views from other members of the panel. I assume that you will be expected to talk about the Greek situation.

Rolf Strauch: Well on the Greek situation not too much I can say as regards to questions. So to the best of our knowledge, in terms of market perception, there is still the view that many help and many investors that Greece would have a followup program, which means that not having one is not fully priced in; that at least is what is our perception.

As to any kind of followup arrangement, principle or fundamental principle of the way we work, is the country has to request a program. If Greece doesn't request a program there will be none. That's all I can say to this.

Lúcio Vinhas de Souza: Other members of the panel that would—please, Paolo.

Paolo Mauro: Sure. I just wanted to compliment something that was discussed regarding the forecasts and the fact that they're often revised downwards. We've just completed the study here at the Peterson, where we look at long-run forecasts, particularly for emerging markets and what we find is that there is a degree of optimism that can be documented. And the degree of optimism becomes larger, the further away, the longer the horizon.

So when I see that we keep revising forecasts down it's not surprising to me. And I did want to mention that the WEO chapter has an analysis of the sources of downward revisions and forecasts. And it shows that the downward revisions are coming primarily from the emerging markets, not from the Euro zone, but from the emerging markets.

Lúcio Vinhas de Souza: One thing that Ayhan clearly pointed out before, he unfortunately had to leave for meetings with ministers is, that if anything the Euro area has performed as exactly as markets have expected. Elena, would you like to make a comment here? Then I would have a question for you.

The implicit message that we have from the very rich presentation that you delivered to us, is that the existing fiscal frameworks of the Euro area and other fiscal frameworks don't properly factor in the costs that are associated with the aging of European societies. Are there ways in which you think we can approach a more robust approximation of those medium to long-term costs within the existing frameworks that we have? You are one of the authors of the paper, so one would presume.

Elena Duggar: I mean, the experience I think there's one—I think one thing that comes out of the work I've done is, I think more research is required in this area. I think we need to get a better sense of—I think aging projections going forward are one there. But I think there's a large space between the demographic transition and how that will impact both the economy and fiscal accounts. And I think there's a lot more work to be done along this area.

Lúcio Vinhas de Souza: That Paolo also wants to make a contribution and we have final question from the floor.

Paolo Mauro: Sure. I just wanted to commend you for doing this work. I think it's extremely important that it's analyzed and it's disseminated. The OECD did this stuff a while back. It's kind of fallen out of fashion. I think you're really re-invigorating it and it's great. There's some related work done by the IMF and its Fiscal Monitor. And I think it's important that all of us disseminate the findings.

I'm just sort of glancing at some of the results here for projected pension spending, projected healthcare spending. And you would be surprised. Some of the countries that have large headline public debts actually have undertaken very significant pension reforms recently, Italy, Greece, many of these. So just looking at the headline public debt misses a big part of the picture. And some of those rankings that most people have in mind are reversed if you look at these more complete numbers. So I think it's a line of work that really needs to be fostered.

Lúcio Vinhas de Souza: Thanks for that, Paolo. I'm happy to announce that we actually have a full research program on the subject. And we are going to be putting several pieces that now [inaudible 00:59:24].

Male Speaker: Thank you. I just want to tie the question of the Greek colleague to what I have understood, is the sort of the average assessments of all the panelists.

On the Greek question as far as I understand it, the President of the Euro TB, Mario Draghi, has basically said that if under the upcoming ABS purchase program some ABS from Greece or Cyprus should be acquired outright by the ECB, that can only happen if there is a program. So at least the ECB has been quite clear that it would like to have a followup program for Greece.

And that brings me to the role of the ECB. Because if it's true that you all seem to share the view that there is some fiscal maneuvering room, but it is limited, then clearly the question is okay, if the impact of this fiscal lever can only be limited is what the ECB has announced so far enough to provide additional stimulus and get the Euro zone economy, if not back on track at least on an upward trajectory? Thank you.

Lúcio Vinhas de Souza: I will open to this for the panel who would like to have a reaction, perhaps. Rolf would have liked to start?

Rolf Strauch: There are two aspects to this. One that you mentioned is about the waiver that was given in the collateral framework for all countries, not only for Greece and that is linked to having a program and therefore not applying ratings. What the ECB will do it, that's then up to their independence. But I don’t think that so to speak, this is the—you can read it as an expression of the wish of having [inaudible 01:01:20] program and I think it’s a statement on the framework as it works. And whether it’s enough or not that’s, I think, the billion dollar question that many people have all over this place and we will just have to wait and see.

Lúcio Vinhas de Souza: Hopefully, this is going to be a billionaire question. So there are no more questions for the audience. I would like to declare the session over in what has certainly been an impressive and extremely productive day. I would like to ask you all to give a round of applause to our speakers.

Adam Posen: On behalf of the Peterson Institute I’d like to thank Lúcio and all his colleagues from Moody’s, as well as our many guests from the official sector here represented by Rolf who took the time to really be with us and engage today. We actually dove a lot deeper than a lot of other events around town we’re doing today and I’m proud of that and I’m proud that together we were able to put together such a substantial program.

Parochially I also am very proud that today was the premiere event for our two new experts, Paolo Mauro and Ajai Chopra, on our stage and both of whom I’m very glad to have with us now and to launch them as publicly PIIE and today was a particular nice thing for us.

We will be doing more. We’ll be working with Moody’s Investors Service, the research arm, and Lúcio later this fall in Dubai. I guess December doesn’t count as fall.

Lúcio Vinhas de Souza: And this should be even in that part of the world around solidly winter.

Adam Posen: Yes. So we will be avoiding winter in a substantive fashion. And with that, thank you all very much. Have a good day.