Unedited Event Transcript

Future of the European Economy after the French Election

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Adam Posen: Good morning, ladies and gentlemen. And welcome back to the Peterson Institute for International Economics. It's nice to see all our European-minded friends here or maybe not all of them but many. We planned this event, a pair of substantive panels, drawing on our own team's resources ahead of the French presidential election, of course, not knowing how it would turn out in the second round. But praying and hoping it would turn out as it did.

There are many things that this then allows us to think about for Europe. And we've seen the phenomenon of suddenly people; I think even Tyler Cowen had a Bloomberg column saying, "Hey, maybe the European economy isn't so bad after all." And people remarking on the fact that we seemed to have a synchronized upswing across an incredibly broad range of European economies.

This is good news. And I will take a little credit to that that at the Peterson Institute many of our colleagues who are going to be speaking to you today, myself included, but certainly not limited to me, we're out there. We're telling people not to panic over the European economy and perhaps not even to panic over the French election over the last couple of days.

But none of us, I think, remained entirely sanguine about Europe's medium-term and long-term future. And at a minimum, we all feel that there is room—you can move my mug, yes, thank you. There is room for improvement in the institutions, in the functioning, and in the economic performance of Europe and not just defined as how to make the Euro viable, although that, of course, is at the core of much of our concerns.

And so, I'm very proud of the fact that the Peterson Institute for International Economics remains probably the most substantively Europhile institution in Washington in bringing in economic perspective on Europe. And as good friends of Europe, it is now time for us to kill whoever has the cell phone and then to—okay—and then to move on to talk about challenging Europe for what it needs to do moving ahead.

We have two panels as mentioned. The first which will be chaired by my colleague, Nicolas Véron, who is, of course, also chair of our fabulous European Breakfast Series and a noted expert on European financial affairs, will talk about fiscal issues and spending. The second panel, which after we bribe you with a brief lunch break will be chaired by myself. And we'll focus more on debt and financial issues. Nicolas.

Nicolas Véron: Thanks, Adam. And I hope my French accent doesn't disqualify me to be a neutral moderator for this panel. We have three speakers, at least two of them well known to you. I will start with Olivier Blanchard who—oh okay. Sorry. We start with Jeromin—with Jacob. Okay. Sorry about that.

So we first start with Jacob Kirkegaard who is known to you as a very prolific and to-the-point commentator on European affairs and political affairs particularly in sort of very diverse climate of European politics and structural reform issues; then Adam and then Jeromin Zettelmeyer who joined us recently and, of course, who was a chief economist as a German Economics Minister until recently after a career at the IMF and the European Bank for Reconstruction and Development among others. So Jacob.

Jacob Kirkegaard: Thank you very much. It's a pleasure to be here again. That is probably actually a very good thing that I am to start because as the title indicates I'm going to talk to you something about what I think should be done about the EU budget. And notoriously, budgetary matters can be rather dull, so better get it out of the way first thing.

But I should also say that the title says "EU Budget." But in terms of conceptualization and thinking about budgetary issues in the European Union, a lot of what I'm going to say could very well also be applicable to what a real Eurozone budget will look like. But my starting point is going to be the EU budget because that's kind of what we have.

So what I want to talk a little bit about today is what does the EU budget look like today and why is it, in my opinion, not sustainable even in the short run given that we're facing issues on immigration as well as Brexit? Then I want to talk a little bit about, well, thinking about a budget or a centralized European budget, what kind of public goods could it, should it potentially deliver? And what does that tell us about the kind of budget that would be required to deliver such public goods and then a little bit about what is actually credible to see?

But the starting point of the EU budget—well, the starting point really is that it's about a $160 billion a year, which for a multilateral organization is obviously quite significant. The breakdown you have here is basically down to the main components of that budget. And the key thing to see

here is actually the green piece of the pie here, which is what's called traditional own resources, which is really the only share of the EU budget that is truly European money. It's essentially sugar duties and customs duties. Everything else, the yellow bar, which is sort of a residual is basically taxes on EU employees' wages and things like that. Everything else is direct transfers on the various forms from the member states.

And that has in the context of the—I would argue--in the context of the ironically the UK budget rebate becomes quite a bit of a problem because what the budget rebate did since 1984 is that it basically gave back the UK two-thirds of the difference between what the UK pays in and what it gets out of the EU budget. And what that construction means is that this is now the way member states think about their contributions to the EU budget. That actually the ability to or how much your net contribution is very tightly controlled. And there is a political unwillingness to pay more than what you basically or ought to pay more than what you get back from the EU budget.

And actually, I would argue for those of you who know American fiscal policy history that's actually obviously many in this room, it's actually not that different to what the federal government budget looked like before the passage of the 14th Amendment in 1913 when this so-called apportionment clause meant that the federal government couldn't tax or could only tax states in proportion to their population, not of course in relation to their individual's ability to pay which basically meant that an income tax was impossible.

But the problem is that right now we're faced with Brexit. That means that about 10 billion of that budget goes away in a couple of years. So somebody else is going to have to cough up that money. But also the other problem is that the EU really does face some very new existential problems that will cost a lot of money.

Number one, I would argue, is external border control issues. It doesn't make any sense to think about the EU as an open area, the Schengen Area free movement etcetera without also thinking seriously about border control and that costs a lot of money. And I would argue that that's not going to be sustainable given this budget. So it's got to change. And then the question is into what.

I would argue then we think about, okay, what kind of public goods could a central budget deliver? Well, you could argue that what a central budget should deliver economic convergence between the member states. Now in an EU context even if you argue that budgetary transfers could achieve that, which is doubtful, in my opinion, but obviously in the European

context it's politically impossible. It will never happen simply because the budget would need to be enormously big.

The second thing and this is where we get into the Eurozone iteration of a European budget. It's very clear that a public good that a central budget could—should deliver is a cyclical budget buffer that we can use in a prolonged crisis, which of course, is what the Eurozone lacked previously. However, it's important to understand that the cyclical budgetary buffer is actually not that easy to do through a regular budget item.

The way that is normally done is, of course, by a central government going into debt, which means we're talking about Eurobonds which is a very different discussion than reform of the EU budget. We should also be clear that there are important budgetary buffers that aren't in the EU budget. I mean the Banking Union, the SRF, and other banking resolution funds are an important counter-cyclical buffer but they're not in the EU budget.

You could also do a cyclical buffer outside the EU budget by, say, take the ESM and give it a banking license and then let it do debt financing from the ECB if you want to think creatively again outside the EU budget. Or you could, of course, choose to have sort of a supplementary European social or catastrophic unemployment insurance. There are things you can do. But doing it in the regular budget is not easy.

And what this chart tells you, it's a little bit difficult to see actually, unfortunately, on this chart. But this is basically just to highlight that geographic redistribution in a budget isn't the same as a counter-cyclical capability. What this chart does—just to give you an indication here—

This is New Jersey that in 2013 paid in net about 8 percent of GDP to the federal budget. And out here on the other hand up here is unsurprisingly the District of Columbia which got about 30 percent of state GDP from the federal budget. And all the EU countries are somewhere in the middle. But the point here is that redistribution is much smaller, and it tends to be structural in nature. This means that this redistribution that you see is from the way that federal taxes and expenditures are structured. It doesn't actually change very much during a cyclical downturn. So the two first items, geographic redistribution and cyclical buffer is not the same thing, and it's not easy to do through a regular budget.

So that leaves us with the last thing that an EU budget or centralized budget, arguably in my opinion, should do which is it should, of course, do the things that we can sort of agree has the most European value-added that is best done at the regional level sort of on an issue-by-issue basis. And again, it's important to understand here that this is a very much a

living concept. I mean this is also what subsidiarity means. It changes over time, right?

Again, I would say that the issue of border control, it's a classical one. Given the demographic outlook that the EU faces in its regional area, it's very different from when the Schengen area was conceptualized in the mid-1980s where you could argue that maybe it didn't matter so much but it certainly matters today, I would argue. So the question is how best to finance these regional level or these issues that are best dealt at the region level?

Well, the first one is I think we can forget about doing it with sort of traditional government finances with direct taxes. And the reason for that is very basic. Europeans don't feel Europeans except, of course, when they're in Washington. So what this chart tells you is basically the share of residents that feels predominantly national or first and foremost national and what you can see across all member states—only Luxembourg, Spain Germany, and get ready for it the UK are countries with less than 90 percent either only national or predominantly national. And when that's the case you're not going to be willing to pay direct taxes to a supranational entity because that's not where your identity is and the other one tells you that it's pretty stable. So you can't do it that way.

Well, how do you then do it? Well, I would argue that if you look at the way the US state, and also the federal budget is put together, one way to do it is through the use of earmarked revenue. And the use of that budgetary invention if you like is actually quite widespread I mean when I looked at it, I was quite surprised to find that the typical state budget actually is more than half financed by either federal grants or earmarked budget revenue.

And so I think since I'm going to argue and since I'm running out of time, let me just go through the last part here pretty quickly and just say that, look. I think what the EU needs to do is because of these political constraints on normal tax payments, going for a single tax for a single public item is a way in which the EU budget should be reformed. And I guess this also applies to the Euro area, by the way. I think it will be much simpler than today and therefore be more democratically accountable.

And when you think about it, okay, some of the applications that you can think of, well, you can have of course explicit user fees. The polluter pays. This is essentially how the Banking Union works. But it's also how the EU just like the US, by the way, is going to start taxing foreigners soon. ETS is the European equivalent of ESTA. It means that everyone with an American passport will soon by 2020 have to pay 5 euros as a fee when you get your visa waiver so user fees.

The other thing you can do is to take a fee on related items. The Highway Trust Fund here in the United States I think is the best example of what I'm thinking about where you basically have road infrastructure financed by fuel taxes and taxes on heavy vehicles. There's no reason why the EU couldn't do that.

And then you can have—of course you can take the taxation to a slightly broader level. And I think why not say if you really want a CAP (common agricultural policy) in the EU budget why not finance it with a specific VAT on food, a related but still pretty broad item. And this just basically summarizes everything I've said. So let me finish there. Thank you very much.

Adam Posen: Good morning again. I'm Adam Posen and I'm here with my speaker's hat on. I am the only one of our six speakers who was not born a European, something I now regret since January. But leaving that aside, I think I will hope to try to do something a little different.

I give Jacob actually a lot of praise for drawing on American institutions and history in a fresh way for inspiration for Europe's way forward. And we have a bunch of work underway in that spirit, thankfully, with the support of the European Commission for such innovative work. But I'm taking a slightly different tack and I don't have slides. I want to make four simple points.

The first one is that we are at the point where the European leadership and Commission have to try to create a European superstate even if it's kicking, dragging, and screaming the voters. We've had this debate back and forth on whether, for example, the Euro can exist with or without a state. Our friend, [inaudible 0:18:10], has been on both sides of that. There is a lot to be said. But at this point, the only fix for Europe is state building in the broadest sociological historical sense.

My second and third points are that there's two traditional ways well-established in history and political science and economics for how to do state building. Number one is to build a military. And number two is to break down local loyalties. And instead of playing lip service to subsidiarity, which I remember when I first lived in Europe in 1992 sitting in Helmut Kohl's office being told about the glories of subsidiarity this obviously feeds exactly the kind of anti-European politics and political economy we wish to avoid. And then my fourth point is why this is practical and not abstract. So let me start with the first.

At some point, one has to wrestle with the fact that there's a reason governments exist. They don't exist simply as a mechanism for the

resolution of market failures as much as the neoliberal consensus would like to have it be that way. They do not exist merely as the repository of people who have nothing else to do who wish to run for office nor even do they exist as a vestige of some prior day pre-globalization when we had tribal things.

No. Governments exist because the exercise of state power is a necessary means to achieving peace and welfare. And I'm sorry to speak at such a broad level. But it turns out that Europe's one way of interpreting European economic history for the last 20 years or 25 years since the 1992 changes is that whatever you tried to do if you try to do it as a coalition of states rather than as a state you are doomed to failure.

And one incredibly oversimplified way of looking at US history which was mentioned in passing by Jacob is until the end of the Civil War at passage of the 14th amendment and all the things that created a genuine state in the US, the US was a dysfunctional entity; a collection of so-called states that had incredible risks and harms involved.

So as we sit here as many of us do and many of our counterparts in Brussels and Berlin and now Paris do and say—and I don't mean to leave anybody out. I could go through the whole Eurovision list except Australia. I don't know why they were in Eurovision this year, but we'll leave that aside.

If we sit there and say this is a serious existential problem. This is time. Then it is time to talk about building the state. And since the voters in many places will completely distrust anything Brussels does, anyways, but you're there, you might as well do something useful. It's not like by holding back you're somehow going to win support. The Commission, this Council of Ministers, have generally achieved what they've achieved when they have provided leadership and when they have moved as the vanguard ahead of popular opinion. Again to make a parallel with the US, the same is true of American constitutionalism. And to extend beyond what I should be talking about in this talk that is how you get rid of racism and sectarianism is you have a strong central government.

So what does a strong central government mean? Again if you go back to the work of say Charles Tilly or Theda Skocpol or other historical sociologists, there would be two major aspects of how you build a state? Number one, you have a military. Now Europe, thank God, was motivated by the desire for peace and the experiences of World War I and World War II. However, there is a difference between saying one does not wish to imagine war within Europe anymore and saying there is no reason to think there cannot be war or need for deterrence outside of Europe or from Europe as a whole towards, let us say, Russia.

This is not my carrying water for President Trump that because he thinks it's somehow going to help the trade deficit that Europeans should spend more on defense. That is a non-argument. The issue in Europe is to consider the issue irrespective of the fact that it might give Trump some pleasure. Instead, we need to think about the fact that whether it was modernizing Russia of the late 18th and early 19th centuries, the modernizing Prussia of the late 18th and 19th centuries, the modernizing US of the late 19th and early 20th centuries, the Empire of Great Britain, and of course France on an ongoing basis mobilizes a military as a means of creating pen across the jurisdiction—loyalties of bringing together young people across borders providing investment in training at a national estate, internationally in Europe's case standardized level, of providing public investment through another means.

And the reality is given where Putin is and given Trump's erosion of the NATO guarantees and given the migration issues which Jacob and others have written on, you need to do this anyway. So use it as a state building measure.

Third point, localism is bad; therefore, completely reconsider the structural convergence funds. We usually think about the convergence funds in Europe as being a very good idea. Anyone who's driven on nice roads in Spain or Ireland or Portugal or Greece is very thankful. Less facetiously, anyone who saw Spain and Portugal get integrated into the European Union after dictatorship is very thankful.

But the fact is when we look at it economically, the amount of convergence within Europe does not seem to have been that great. That in a sense is one aspect of the crisis that we had and the vulnerability that we had. And it is very clear whether one looks at the transfers to Wales or to Southern Italy or to Northern Portugal or pick your favorite spot that with the exception of Ireland in general putting in transfers under the convergence fund's criteria actually reinforces labor market rigidities, decreases flexibility, decreases the ability of cross-border labor markets, encourages exclusion of young people from work, and so on.

Again, there is a strong US parallel. The extreme case is, of course, Alabama, West Virginia, and so on where we have done major transfers through the years. And all it does is entrench people who vote against the transfers that they're getting. It's time Europe faces this and starts thinking about funds for individuals as European citizens rather than as convergence funds by region, which feed politics that are anti-European.

So to conclude, if we're going to think big, think historically big. If we accept that Europe is not fundamentally where it should be, I would argue

that the biggest gap is the lack of a true state. Politically, it seems impossible. On the other hand, it seemed impossible in many other contexts where states were created. And you're going to be hated as a European leader, anyway. So you might as well try to build something.

The two obvious places to do it are by building up a military and by diminishing the convergence funds on a regional basis replacing them with other forms of transfers that are more individually oriented. That's my thoughts. Thank you.

Jeromin Zettelmeyer: Okay. So thank you so much. So I found myself agreeing with both Jacob and Adam. And I wonder whether that's a contradiction or not. But I'll let you think about that.

So in terms of ambition, this is going to cut somewhere in the middle between the two. And it's going to get geeky again just like Jacob in a different way. So the basic argument I'm going to make is that for political as well as economic reasons, the EMU needs to rethink how it resolves the issue that domestic economic policies in the currency union have bigger spillovers on each other than outside and hence needs to be coordinated somehow or incentives need to be set to make the whole thing coalesce.

And so the basic idea is that in the past, EMU has really depended disproportionately on rules. And I think that that has increasingly run its course. And instead, we will have to think about a smarter combination that relies on several things. I think there's still some role for rules. But I think there should be a much bigger role for market discipline and for delegation to common situations. And these things are not in contradiction.

Now if you think about what it means specifically, there are two difficult bits to this. So one, like the previous two speakers I do agree that we will need common fiscal institutions. And the space in which I would sort of shoot is the space in the second bullet in Jacob's presentation which was the notion of having budgets with a stabilization or a counter-cyclical purpose. So I think there is a role for going in that direction. But it can only be gradual and it's complicated.

And the reason why it's complicated is that it seems to me that in the foreseeable future in Europe we cannot go much outside the perimeter. If you think of Jacob’s nice redistribution chart, right, where there was sort of New Jersey with minus 8 percent and the District of Columbia with plus 25 percent. But then you have the same redistribution within Europe in a much narrower away. So the bottom was—I don't know—something like—0.5 and the top was Hungary with plus 5. So I don't think we can go much outside that perimeter.

And in fact, I can tell you for sure that Germany will only agree to fiscal institutions to the extent that they're motivated primarily by civilization, but do not then have this consequence that they also increase redistribution in a systematic way, in a predictable way.

The second important point is the following: So many people call for more market discipline. In fact, we have a no-bail-out clause in the European treaties. But making that credible is really, really difficult. And making it credible at a time when we already had the crisis behind us and it's left us with a lot of debt and re-balance sheets is even more difficult because any sense of increased market discipline can create a crisis.

Now, my claim is that if you think about these problems hard enough you can actually solve them. And in this presentation, I'm going to give you quickly some thoughts on how to address the second point how to credibly increase market discipline in the Euro area.

So just to recap the motivation, so the starting point, the reason why I've called this a politically motivated thinking about EMU reform is this recognition that everyone seems to hate Brussels. So in theory, we have fiscal rules that will prevent debt crisis and underpin ECB independence. This is how they were intended. In practice, these rules create a political as well as an economic problem because everyone's constantly blaming the Brussels but in different ways and for inconsistent reasons. So the deficit countries blame the rules for protracted austerity and resent the micromanagement that comes with the enforcement of the rules. And the surplus countries don't like the fact that actually Brussels quite predictably makes some compromises with the deficit countries.

And so the sentence that you see there, the Commission has lost its role as the guardian of the treaties. This is probably the sentence I have heard most often in my two-and-a-half years in Berlin. So that is the view from the other side. So Brussels is resented and scapegoated from all sides. And the problem is that this is not just a problem for the Euro. It's a problem for the European project because Brussels is symbolic of the European project. So we meant to get out of the system, which forces us to be constantly at each other's throats. And this is sort of the main insight I had from my time in in Europe.

But we need something to replace it. And what is that? In my view, it must be market discipline because I don't think there is any other way of doing it unless we go to full institution integration. Central state building is definitely an alternative solution, but we are not there yet. Even though I do think we should do the things that Adam recommended.

Now, the complication of going for more market discipline is it's not really credible to put marketers who have been sovereigns if this potentially creates large collateral damage on the rest of the economy. And currently that is built into the system through the sovereign exposures of banks. So anything that we do to sovereigns that puts on the screws be it simply making yields more spread out in Europe, more sensitive to economic policies, or of course in the extreme case the sovereign debt restructuring immediately gets translated into the banking system. From the banking system into the private sector, it creates the doom loop. It runs counter to the very essence of EMU which is financial integration. I mean financial disintegration or fragmentation is what happened through this particular challenge.

And so, a reform that goes in this direction of trying to extricate sovereign balance sheets and bank balance sheets is essential. But it is also extremely difficult at a time when both of these balance sheets are weak. And so, the simplest example is the German approach to reducing sovereign exposures in banks would not work because it would precipitate a crisis. You cannot simply have a regulatory response per se because of its massive implications conditioning on kind debt stocks.

This is in my view where this whole safe asset debate comes in. So in my view, the notion of combining regulatory reform with the introduction of some sort of safe asset that would be free of capital charges and would take the role that it’s currently taking by national debts is the only way to actually solving the doom loop problem and by doing that giving market discipline a chance.

And so, what I'm going to do in sort of my five minutes or something that I still have is give you one example of how I would go about that. So here's one particular way you could do a safe asset [inaudible 0:35:03] another one. But this is a particularly simple one that shares some of the traits.

So you could extend the role of the ESM or you could create a sister institution that shares some of the ESM's traits particularly it would be a preferred creditor just like the ESM. And it would do essentially the same intermediation that the ESM does for crisis countries for normal countries. So what ESM does right now is it buys loans if you like. It extends loans. It buys loans from crisis countries. And it finances this by issuing its own debt.

And so, the idea is that you could do this in normal times by buying bonds of member states financed by bond issuance. And the bonds issued by the ESM would be senior to national bonds; and because that, they would be much less risky particularly if they're not too much of them. So if the

buffer if you like that's created by the continued presence of national bonds as large relative to the bonds issued by the ESM. But you might have some residual risks.

So in the past, those that you know the [inaudible 0:36:14] will understand that what I'm proposing here is just a special case of the blue bond/red bond approach. And in that approach, of course, that residual risk was covered by joint and several guarantees. And proposing not to do that here because it's politically impossible and it's unnecessary. You can do it by just increasing the capital of that intermediary a little bit. The original blue bond/red bond proposal did not have an intermediary. You're just going directly for the guarantee.

Okay. Now, the question is how much would we need? So how big would this have to be? And so this is just some examples for the Euro member countries. It gives you the government debt outstanding. It gives you the fraction that is in the bonds— what's the trick for switching this one? Oh here it is. Yup.

And then this is the bonds that are held in the Euro area banking system of these various countries. So you see the biggest as you would expect is Italy, which is just under 30 percent and of these 30 percentage point of GDP, Italian GDP worth in bonds, 22 percent actually in the Italian banking system itself. So this again shows you the fact that these numbers are fairly close. It shows you how concentrated debt is in national balance sheet.

And so, if the objective is to replace basically this stuff, the sovereign bonds of Euro area members in the balance sheets of the banks of Euro area members, you would need about 30 percent of GDP. In fact, you would need less because most of these numbers are less than 30 percent of GDP. But if you provide 30 percent of GDP, essentially, you would have enough to replace that in full and also you would create demand for issuance of the underlying bonds that get baked into the safe asset which would ensure that there's no net decline in demand for Italian bonds.

So how it might have worked in practice? Well gradually. So you create this new intermediary or you give the ESM this new function and then you begin bond buying and issuing operations as the bonds that are currently in the balance sheets of your area banks mature. And the way you do it is that from that point in time when the ESM takes up these functions, the newly issued sovereign debt of Euro area sovereigns would become subject to a capital charge or some other regulatory incentives so that banks do not want to hold this. This capital charge would not apply to the sovereign bonds that are already on the balance sheet. And it would not apply to bonds issued by the ESM.

And so in each year, the volume of these ESM bonds that are issued based on buying national funds would be calibrated to replace the maturing sovereign bonds on bank balance sheets. Now as you know, one consequence of this is that because you're issuing senior debt, the marginal cost of national debt issuance would slowly rise because it becomes increasingly subordinated. However, and this is a very important point, because at the same time, this institution is buying 30 percent of total debt issuance or up to 30 percent at nominal rate value at face value, on average the total cost of debt for these high-risk balance would not decline.

So I have no time to go through this. But I gave you a back-of-the-envelope calculation of what the impact on marginal issuing cost would be for Italy. So these are the Italian numbers. I don't have it on the slide. Basically, this is the current Italian 10-year yield. This is the current German 10-year yield. I have assumed a loss-given default of 50 percent. And that applies a probability of default of about 3.5 percent.

And then what you do through the subordination effect is effectively you are forcing a smaller number of bond holders to share a particular loss. And that's going to raise the marginal cost of the debt. By how much? Well, in this calculation by about 60 basis points so it's not dramatic. However, the total interest cost of that country cannot rise. And that has just a strong in logical reason which is on this slide and which I don't have time to go through. But it's impossible for the total cost to rise.

Okay. So I'm basically done. My final point is that I wouldn't do this in isolation. I would do it combined with other reforms of the fiscal framework, some of which would be further market discipline enhancing like legal changes to make southern debt restructuring more orderly possibly legal changes that make the ESM a more conservative [inaudible 0:41:17], make it less likely that insolvent countries will be bailed out. So this is a bit along the lines of the IMF's exceptional access policy.

And then, of course, with more market discipline out there, you would have [inaudible 0:41:29] for reducing reliance on the Stability and Growth Pact. So I wouldn't mind scrapping it completely. I don't think that will go. But you can simplify it and you could give countries maximum flexibility to conduct expansionary fiscal policy in a recession. And finally, I would go for a small Euro area budget for aggregate fiscal stabilization purposes. Thanks.

Nicolas Véron: Thank you, Jacob, Adam and Jeromin. So now we are moving to the panel discussion phase of this session, and I'll give the floor to the audience very quickly. But let me just start with an introductory question to all three of

you, which is connecting it back to our title for the whole event, and the macro political or Macron political climate that is being created by the French election.

And I'd like to have your views individually on how you feel the climate is different from what it was before on several counts. Obviously, there is a different assessment by the marketplace of the likelihood of the Eurozone unraveling. Even so, Italy is on investor's mind. And there is certainly no place for being complacent about the crisis being over. But also a different political equation in France and Germany if we fast forward to early October, a situation where both France and Germany are clear of immediate general election schedules for the next few years.

So how do you see a structural change on the climate in terms of the climate for Eurozone reform? Or will we basically hit the same obstacles as we have repeatedly run into in the last few years? Maybe starting with you, Jacob.

Jacob Kirkegaard: I mean there's obviously always the risk of getting stuck on something. But I would say that the risk of that happening now is probably in my opinion lower than it has been for many, many years. I mean just in terms of election arithmetic, this is the only time in 20 years that France and Germany will vote in the same year because of the differences in the four- and five-year respectively mandate. So now you really do have after these elections more room than you will for generation basically until these two critical countries go to the poll again.

Secondly, I mean I think it really does make a difference the way that Mr. Macron was elected. The prominence of the pro-EU platform and the basic—really I mean the promotion of a pro-European platform as the stark contrast to the Le-Pen-Trump nationalism platform really do make a difference. He does in my opinion have much more political capital than a "normal" French presidential victor would have had when it comes to if you want trade-away French sovereignty to some extent.

And then there is Brexit. There is a very concrete challenge that the EU will be facing in the next months and years that will require an institutional response which wouldn't have had the same urgency in a non-Brexit world. So I do believe that the stars are well aligned for a big grand bargain—we can debate what that grand bargain will entail. But, yes, I think we are in as about as good a place as the Eurozone will be probably for generation for something major to happen.

Nicolas Véron: Adam.

Adam Posen: Like Jacob, I'm somewhat optimistic, but for a slightly different set of reasons. First is that the Russian threat means that Nordics, Baltics, and particularly other Eastern Europeans who might have gone a nationalist route still even if nationalists see a very strong interest in supporting Europe and being engaged with Europe [inaudible 0:46:40] of course may be a weird exception to this. But as our colleagues—I mean [inaudible 0:46:46] has written about this as a very serious matter. Again, sorry to bring in the security as well as the economics, but I think it goes together. It reinforces the fact that Poland and the others do not want to be too anti-European because of what's at stake.

The second point is one that kills me, and I'm looking at some friends in the audience, but which has to be acknowledged. The center-left in Europe has been wiped out in party terms in place after place. We just saw the Nordrhein-Westfalen elections in Germany. We've seen the Socialist Party again looking around at various friends of mine here essentially get replaced by En Marche or whatever I'm supposed to say. In the UK, similarly we've seen the Labor Party basically turn into a caricature of itself.

I mean the broad political trend in Europe including the UK is the death of the center-left. As that's the place I would personally feel most at home this is troubling. But from a getting things done perspective, this means that the center-right parties essentially can absorb a large number of the centrists and make deals with what's left of the left.

And then the third reason I would be optimistic about doing things including the very specific things, Jeromin's very sophisticated proposal, Jacob's specifics, my specifics though grandiose, is because we've, I think, lost the illusions now that you need to constantly get buy-in from people. If you can claim you have a mandate with 48 percent of the vote or even a mandate to change the constitutional relationships with 52 percent of the vote in the case of the UK, there's no reason for a Macron under the French presidential system to pay any mind whatsoever to the Le Pen voters. He should just go for it.

Nicolas Véron: Jeromin.

Jeromin Zettelmeyer: Okay. So you now have forced me to comment on the election. No that's fine. So I think that we probably have gone from one overreaction which was to believe that Schulz was the messiah and he was literally portrayed as the messiah on websites dedicated to him into thinking that it's all over after, not [inaudible 0:49:14]. And the center-left in Germany which we thought was resurgent might get crushed like elsewhere.

So I don't think that will happen. I think that the likely outcome is that Macron will be the next chancellor obviously, but with a stronger social democratic either opposition or partner in government than they had last time around. So in the national polls, he's still polling at around 30 percent and that's exactly what the result was [inaudible 0:49:44] as well. And so that does, I think, give one hope that some of the center-left sympathy between Merkel and the social democrats in Germany will permeate the new government.

Now, the difficult person to convince obviously will be Mrs. Merkel. And so, how can one do that? So if you look at sort of the conservative position in Germany, it's basically characterized by two sets of beliefs. So one is that no support for any reform that would increase redistribution or in their view dilute incentives for fiscal discipline and structural reform in Europe. And number two, a generic low or near-zero willingness to take risks with respect to unintended consequences. So I've often had discussions where people have told me. "Well, Jeromin, this looks great on paper. But in practice, it's not going to work out like that, we'll get screwed.

And so, I would say that the second bit is really the big difference between the conservatives that are predominantly in the CDU and CSU and the more European spirited that are predominantly in other parties but also exist in the CDU and CSU. It's this willingness to take risks and engage in reform that may have unintended consequences for the better of Europe.

And so if I were Macron, I would try and divide these two things. So you're not going to get Germans on board of whatever color if you go for EMU reforms that are primarily about increasing redistribution. That's not going to work. But I think one can go for reforms. I mean one can write down reforms that are redistribution in the neutral ex-ante. So they do not systematically benefit [inaudible 0:51:49] countries versus others.

But they're stability enhancing. They're efficiency improving. They ultimately benefit everyone. And, of course, they could be abused. They might not work. But if you have a good reform in the sense that it hangs together, it increases incentives. It makes the system more efficient. Then I think one can appeal to the European spirit. Then let's say, "Look, of course, it might have unintended consequences but we have to take a risk."

Nicolas Véron: Maybe as a brief follow-up to this, we're entering a phase in the German election polling where it's become impossible to envisage other coalitions into a grand coalition. And it could be the case that this time the SPD is not in government, but is replaced by a combination of FDP or Greens or both. Can you walk us a bit through the implications that would have for Germany's European policy?

Jeromin Zettelmeyer: So there is a nice website that translates every poll in Germany into a seat allocation in the Bundestag. And from there, you can see what the feasible coalitions are. Now, I have not looked at it again this morning since last time I looked at it was before our China trip at the beginning of May.

But what you see there is that the grand coalition obviously is always possible. And then in about half of the polls or one-third of the polls, the so-called Jamaica coalition which is CDU liberals and Greens is also possible. And then very rarely do you see majorities for a red-red-green coalition. I mean that's essentially off the table it appears now.

So Ms. Merkel's preferred coalition I'm sure would be Jamaica. However, the problem is that not just have the Social Democrats lost, but the Greens are doing very poorly. And so, it's not at all clear whether there will be a majority for that alternative coalition. And if there is not, we'll be stuck with a grand coalition.

Nicolas Véron: Jacob, any comment on the policy possibilities opened by Jamaica or whatever other island?

Jacob Kirkegaard: Well, I think first of all, we should note that the good news from the German polls is that the AFD is probably may not actually even get into the Bundestag that that is quite a remarkable turnaround from just six to nine months ago. But it would also be said that I mean I think it's somewhat conflicting. I mean in such a coalition there's no doubt that the CDU especially led by Angela Merkel who probably more or less would claim personal credit for such a victory because part of the reason that she would win if it were to be a Jamaica coalition would be because her personal approval ratings are so far ahead of Mr. Schulz. The CDU will be sitting at the end of the table. And it's not in my opinion really clear what the other coalition partners could really hope to get on these big issues.

And then when you look at the position although the position of the FDP has been somewhat shifting over the last couple of years, but this is not the party of Hans-Dietrich Genscher anymore. It's a much more Euro-skeptic sort of libertarian Europe skeptic party than it was. So it's not clear that the FDP would be on board with a lot of more integration.

On the other hand, the Greens may have that, a more pro-European orientation. But at the end of the day, it will be Mrs. Merkel and Mr. Schäuble who will have really—I would argue—a much more personal influence in a Jamaica than a grand coalition on this set of issues.

Nicolas Véron: Thank you. I'll open it to the floor. You know the rules. There's a microphone at the end and the microphone here at the front. Please introduce yourself before asking questions which may be succinct, please.

Luigi: Thank you. Good morning, everyone. My name is Luigi and I work for an Italian bank who sits on—I believe last time I looked at that was like 8 percent of the entire Italian public debt. So my question is for Jeromin, but obviously open to comments of the other distinguished speakers.

I really like your proposal on your plan despite the fact that I work for an Italian bank. I have always thought that the preferential treatment that sovereign assets receive in the balance sheet of banks creates a lot of distortions which really need to be tackled. So your proposal is very welcome.

However, I believe and I would like you to comment on this. I believe that a proposal should also be made on the liability side for banks because one of the reasons why a bank like ours sits on 8 percent of the Italian debt is because yields are slightly higher than buying German debt or French debt. And when it comes especially to the dollar market, we pay a very high price when we have to put together dollars because we are a triple B bank in a triple B country.

So it's very interesting what you say on the asset side. But don't you think that this plan will be completed somehow by doing and tackling something on the liability side? This probably comes with a more united Europe. And I think Adam probably will have something to add on this. So a more united and a more homogenized Europe probably would benefit also banks like ours Thank you.

Nicolas Véron: Jeromin.

Jeromin Zettelmeyer: Okay. So, of course, part of reasons why your funding costs are higher is because you're very exposed to Italian debt, right. It's a catch-22. It's precisely it's the doom loop. And this is about destroying the doom loop. And so I think funding costs would go down because you would be holding the same assets—not exactly the same. Obviously, you still have a big exposure to Italy through regular lending to the private sector. But your balance sheet would look more similar as far as sovereign exposure is concerned than that of banks in other European countries, number one.

Second, I think that maybe not immediately, but over time a scheme like this should improve the rating of the Italian government too because they are also vulnerable through the doom loop. And presumably, increasing marginal debt cost would create strong incentives perhaps more effective incentives for fiscal consolidation than is currently the case and less stupid stuff, less counter-cyclical fiscal policies—I mean pro-cyclical fiscal policy stuff. So it is it is supposed to be a package.

But I do realize this is not the only reform. So I also think we should probably have something that can occasionally create a fiscal impulse at the European level which is what Germany is supposed to do now. But of course it won't because it's not in its domestic interest.

Nicolas Véron: Adam, do you want to add something?

Adam Posen: No, I was just smiling because Luigi's absolutely right to say as clever as Jeromin thing is thinking through the liabilities it's important. And Jeromin is, of course, motivated by ending the doom loop and thereby having a salutary effect of the liabilities.

Nicolas Véron: Other questions? Yes, please.

Helge Berger: Thank you. Helge Berger with the IMF. We also have some European debt on the balance sheet So on your suggestions from all of the panel, I think we'll need in the end a little bit of everything. If you look at other countries and let's take the US or Switzerland, how do they organize themselves? They do share fiscal risk. They do have a Banking Union. They have credible no bail-out for these reasons. I think Italy, they still bring down other countries even if we split the doom loop just for the banks because it's a large economy. And the macroeconomic spillovers will be large. So some risk sharing is probably in order.

My real question is on the politics. You all seemed to be splendidly optimistic. And I hear this with gratitude. But what has really changed? I mean so let's assume there is no change in Berlin. I think that's a fair assumption. If there's any change in coalition, it will exclude the SPD and then arguably the whole [inaudible 1:00:23] in the government and the people sort of will think equally will be strengthened and not weakened.

So the change is really in Paris. And what was the story about Paris? The story was, well, if you want progress in terms of risk sharing and governance in Europe we have two problems. One is in Germany; nothing changes. The other one on the risk sharing side, the other one is on governance, the willingness of the French government to actually give up the right on national sovereignty on all these policy lines, military for Adam, fiscal for Jacob and so on. And for Jeromin, French banks are pretty much still part of their goals of the target function of the French government. So how much change is there really? And those with the French accent could probably answer that first.

Nicolas Véron: Jacob has become an honorary Frenchman when it comes to political analysis. So I'll start with him.

Jacob Kirkegaard: No, I mean I think you're right. I mean no matter what happens at least in my analysis, the change in Berlin will be incremental. But the broader environment that Europe, the EU, the Euro faces itself in is rapidly changing. I mean we have the transatlantic relationship which is changing because of what's happening in this city. We have Russia as Adam mentioned.

But Turkey is a really, really, really big change. If you predict, which I do that in the next six months, the end of a membership negotiation is imminent. Turkey is for all respective purposes turning into a slightly southern version of Belarus, again, I think it raises the necessity for German European leadership. And I don't think we should underestimate this is you would think although you never know given what the alternatives are in the CDU. But this is likely to be Angela Merkel's last four years. So I wouldn't necessarily rule out and she knows. She took a big risk with refugees. She got burned. She's clearly survived it. But she's not the completely risk-averse person, although I agree with what Jeromin said that her party [inaudible 1:03:00]. I wouldn't rule it out.

On what has changed in Paris, well as I already said, I mean I do think that Macron the way he won makes a difference. He has better opportunities to trade away sovereignty for fiscal integration. But I think there is another component there what has changed

I mean if you look at these when I read the program, the economic domestic reform program of Mr. Macron, it's a pretty good program. And if he's able, with the parliamentary majority behind him gradually implement a lot of that, there’s real change both in the performance of the French economy but also in the performance of relatively French credibility in the eyes of Berlin that makes things possible that weren't before. So no, again, I will stand by my, shall we say, euphoric optimism about what is suddenly possible.

Nicolas Véron: Adam.

Adam Posen: Let me continue in Jacob's spirit in a particular way which is and I tried to say this in some of my earlier comments. The external environment matters a lot. I mean for obvious reasons we were all very concerned about the French election. But the external environment as Jacob said you think about Turkey and immigration. You think about Brexit. You think about Russia and NATO. You think about Trump administration that is threatening Germany's currency and all these things.

And this is an environment that I don't want to be too European functionalist in manner. But if you look historically over time, external

environments are strong drivers of state building. External threats and changing needs of interdependence are strong drivers of state building.

And so the idea that Europe lived in first in the suspended animation of the Cold War particularly for Germany and then in the euphoria of the post-Soviet Union not only German unification but of course the entry of so many new member states that finally, okay, we do have the return to history. And that does have an effect. So actually, I don't feel it is driven by Macron except in the sense that we didn't end up with Le Pen.

Jeromin Zettelmeyer: So I agree with that and I want to add two points. The first one so the question is why would a future Macron government will be more receptive for any of this stuff than a past Merkel-led government? Well, the first point has already been mentioned by Jacob because of Macron.

So, one way of putting it which is the way that the last economist framed it in the [inaudible 1:05:55] column is calling Germany's bluff. So Germany's always insisted, no, no, we are not going to do any reform because first things first. The first thing is to do reform in your own country. And so, Macron might just do it and in which case it would be very difficult for Merkel to say, "No, I'm not talking to you on Euro reform."

The other thing I do have this faint hope that the Social Democrats might gain enough votes, say a swing of 5 percent relative to the last election to get the Ministry of Finance. So that's not completely impossible. So a grand coalition with a stronger Social Democratic presence and more courage to talk about Europe than in 2013 where Europe take no role in this bloody coalition treaty could be one way there.

And the other point I wanted to make is that none of the proposals that were made by Adam or Jacob from different sides strike me as particularly taboo for the Germans; this idea of common defense spending. What country to embrace that more than Germany? Then basically what Adam wanted was sort of European flexicurity type arrangement where individuals get this money rather than—I think Germany should be sympathetic to that. John Pisani wants something like that for France. So that Macron maybe they can coalesce on this idea let's look at the structure of funds again and give it to people rather than to regions.

And then also your ideas on let's have spending items that are earmarked in the sense of having political purposes attached to them that's an idea that politicians like a lot, I think. So I think there's some stuff there. We're just going to have to write that memo to them.

Adam Posen: That's actually the Institute's job is to do that. I'm hoping Jeromin is right about perhaps changing or pressuring the German finance ministry industry. As Helge knows, the IMF just released its statement today on Germany needing to invest more, spend more, cut taxes.

However, I don't want to give up Jeromin again back to the German government. I like him here.

Nicolas Véron: Yes. We have first here at the front table and then Krishna.

Krishna Guha: Thank you. I'm Krishna Guha of Evercore ISI. I wanted to ask a question on timing and sequencing rather than necessarily substance of some of these safe assets and other proposals. It strikes me as we look to next year we've got an ECB that's very likely to be winding down its QE program where it's a little early, a little late, a little faster, a little slower, but exiting QE. And we have banking supervisors who, while not yet imposing any capital charge for sovereign exposures are cracking down on sovereign holdings of banks including in places like Italy. So we have one blade of the scissor moving already.

The question is can we move fast enough on the other side to get a balanced set of transitions with some safe assets moving forward other changes of the kind that Jeromin described to create a balanced package that generates a sort of path to stability as opposed to what I fear which is in a sense these two timelines may not fit together very well that even if there's some talk and hope of moving things forward on the institutional front [inaudible 1:09:20] .The reality is these won't happen quickly enough to deal with the potential spread widening and other issues around ECB exit.

Nicolas Véron: Now, I suggest we take Bill's question as well because we're getting close to our cutoff time so we can answer those two before breaking for lunch.

Bill Cline: Right. It's also on the same issue. This is Bill Cline from the Institute. To me, it seems to me the key in the broader picture is to make Greece sui generis. We don't have defaults in the main European countries going forward. So if you start from that point of departure, it helps I think inform a different way of looking at it. It does seem to me, Jeromin, that you could get essentially what you need by having some risk weight attached to any sovereign bond that has a spread of more than X percentage points and from the way the comment was just made maybe this is already happening.

And the second part of that would be that you would have a limit to the fraction of assets that could be held in own country sovereigns because the problem here is the political pressure to lend to the own country. That

seems to me like it would be a quite feasible thing that could be phased in. And I think it's very important to remember that the only place where the doom loop went from the sovereign to the banks was Greece which again says that the issue is to make sure that Greece is a historical exception.

Nicolas Véron: Jeromin.

Jeromin Zettelmeyer: So that's sort of the German view, right? The idea of we're going to do everything through a regulation and it is called a complete non-starter because it has huge asymmetric impact on European countries. It would be great for Germany. It would be terrible for Italy. It would kill the Italian banks. It would lead to a large increase in the financing cost of the Italian debt. So we can't do that. We have to combine it with something that diffuses in more neutral right. And that's why this carefully synchronized introduction of a safe asset at the same time, I think, is the only way to go.

And on Krishna's point, so I don't think that actually the regulatory treatment of the supervisory, I mean, you may have better insights on how it works. But certainly in terms of change of regulation, it's not that these things are proceeding in two different tracks. They are both [inaudible 1:12:07].

So Germany is called for change in regulatory treatment of sovereigns. And it is holding both and most importantly the European deposit insurance idea and the safe asset idea hostage to progress on that front. And one has to unlock both at the same time.

In the meantime, the ECB and specifically the ESRB is reviewing the safe asset idea and has proposed to have introduced this in a very marginal way without actually changing anything on the regulation. And that in turn is being seen with great skepticism on the German side. So I think both will have to move together.

Nicolas Véron: For clarification, you just mentioned to ESRB not the SRB—the European Systemic Risk Board.

Jeromin Zettelmeyer: That's right.

Nicolas Véron: Jacob.

Jacob Kirkegaard: Just on Krishna's point about the timing and whether or not these two issues are in sync. Well, I mean I think if you look at it, you said that you're afraid that this might happen until spread starts to rise. Well, I guess I would probably say that if spreads were to rise, good—well not necessarily, actually, I would argue precisely again because we are in a world let's say—okay.

Let's give a scenario that says the ECB begins some sort of tapering early next year or at least before the Italian elections which are pushed until the end of the window in May for obvious reasons. You end up with a Parliament in Italy that doesn't immediately produce a viable government. You have a widening of spreads. And in the worst case scenario, you end up in a program.

Policy conditionality there in Italy will have to be—there isn't the need to do much structural reform really on pensions or austerity given the starting point. But nonetheless, there is significant policy conditionality. The ability of any government in Italy to sell that conditionality could be predicated on the simultaneous creation of safe assets in the same way that Cyprus keeps clinging to debt relief to sell stuff domestically in Greece right now.

So I don't see why you couldn't actually have a scenario in which these two issues actually go simultaneous. In fact, when you want institutional reforms in Europe, I think the lessons of the last couple of years is that a little spread widening is typically I would think.

Nicolas Véron: Adam.

Adam Posen: Just both my colleagues made very sophisticated answers to your excellent questions. Just two additional points, Bill. In terms of Greece being sui generis, two thoughts. First is, it can't be because it looks like Portugal is in a real mess. And I'm not sure -- we may publish something on this soon. But I'm not sure that you can make it sui generis if you're going to have to do something for Portugal as such as since Portugal had been a good child in the sense of doing the reforms and complying and not sending nasty people into meetings and so on.

But the flipside of that is, again in my, I hope not too outlandish dream of the state, it goes back to something I've been now saying for going on 10 years almost. The point is Greece and Portugal should become West Virginia and Alabama which is or as I put it if you have a marriage between France and Germany; Portugal and Greece are the members of the family, the drunk uncles who you don't want out on the street. You just have to accept that they're going to be these small poor states that are part of the Union and that's life and you try to erode. Make young people leave those places so they have possibilities and you write them off.

And this goes to the stuff Jeromin was talking about. I mean the question of Germany has always been why the hell don't they write them off? I remember standing in 2010 in Berlin. And again, Olivia and others can trump me on these kinds of stories. But I remember standing there in 2010

in Berlin nearly screaming at a very senior German official saying just write a goddamn check and make this go away. And, of course, they won't. But in the end that's where it has to come up full stop.

The final thing going to Krishna which I'm going to do less sophisticatedly than Jacob did, I think it does matter that some of this is ECB and some of this is Commission. And the fact that some of it is— what is it Nicolas? What's the thing the ECB uses to beat up the banks?

Nicolas Véron: Single supervisory mechanism.

Adam Posen: Thank you, the SSM. That is a different entity and ESM is a different entity. And so, there is some room for play here. And particularly and again you're better to judge this than I am, Krishna. But particularly when we're starting to talk about who succeeds Mario Draghi at the ECB and we're also going to have to replace Praet and Constancio and [inaudible 1:18:00] all in the next couple years. There's a lot of room for deals to be made. I'm not saying they will be made. I'm not saying it's inevitable. I'm just saying I think that adds a number of degrees of freedom for these kinds of deals in the next couple years that weren't there a couple of years ago.

Nicolas Véron: So the bad news is that we are over for this session. But the good news is that we continue the discussion after lunch and please join me in thanking out panelists for what, I think, was a very stimulating discussion.

Adam Posen: Okay, ladies and gentlemen, let us call to something of order between the French election and that highly uplifting optimistic panel, I understand there's great exuberance in the room, and it's not just due to lunch, so that's good. We continue now with our second panel of Peterson Institute for National Economic Experts on Europe's Economic Future, combining less diagnosis of problems than we're used to having recently, and more proposals and forward looking for what goes forward.

Our previous panel talked about fiscal issues and spending. We're now turning to the other side of the macro equation, monetary and financial policies. We'll be leading off with of course, the best, Olivier Blanchard, who has been the inaugural C. Fred Bergsten Senior Fellow here since the position was created in October 2015. But of course, prior to that, had served as Economic Counselor and Director of Research at the International Monetary Fund throughout the global

financial crisis. And had his incomparable academic career at MIT. Olivier will be addressing price and wage adjustment, a critical issue.

We'll be followed by Jérémie Cohen-Setton. Jérémie is making his debut on our main stage today, so be nice. Jérémie joined us a few months ago as a Research Fellow. Every year we try to take in for a few years some younger folk, believe it or not. Jérémie is a recent graduate of Macroeconomics and Economic History at Berkeley, has been doing some very interesting work on insights from US economic history on the effectiveness of the common currency area.

And then finally speaking will be Nicolas Véron, who you saw earlier in the role of moderator. He's been a Fellow at the Institute since October 2009 and he'll be giving his latest update on the progress and perils of European banking integration.

But please let me begin with Olivier Blanchard.

Olivier Blanchard: Good. I am also new to this stage, Adam. This is actually the first time that I stand behind this podium. So be nice to me as well. I am afraid that I am the bearer of bad news in the sense that I think there's a problem with the Euro architecture, which has not been addressed and is difficult to address and that is what I want to talk about today.

I think my eyesight is not good enough to read my own slide from here, so I will look at them from here. The discussion of Euro reforms has focused on two legs, rightly so. The first one is the banking union for the reasons that we have all discussed, including this morning. And the other is fiscal union, again, for reasons that we discussed this morning. And it's, there's no question that these are two essential legs. But what I want to argue is that there is a third leg, which is just as essential, which is smooth and rapid adjustment of relative prices within the Eurozone, which is a different beast from the first two and has to be considered.

So let me go through the quick macro course, the very short one, which is why do we care about relative price adjustments in the common currency area such as the Eurozone. Now I think countries can be affected by two types of shocks conceptually. The first ones are shocks to internal demand. And then the right tool is clearly to push up aggregate demand full fiscal policy, which presumably is a tool, at least we hope is a tool that the countries have, and that's the right thing. You basically undo the weak, private demand by stronger public demand and the problem is solved.

If a country, however, is affected by weak falling demand, that may come from a steady loss of competitiveness or whatever other reason you can think of, but typically the loss of competitiveness, having happened for a while. Then the right solution is obviously not fiscal policy. It is the adjustment of relative prices.

Now, how is this supposed to happen. Well, the standard mechanism is if you have weak falling demand output goes down, unemployment goes up, wages adjust on the downside, prices reflect the decrease of the [inaudible 0:05:18.9] in wages, relative prices decrease, you become more competitive and you re-establish both internal balance, output goes up, in external balance your current account deficit or your trade balance decrease. And that's a mechanism which is essential to solve the problem.

Now in that context, it is actually quite important to remark that fiscal policy is exactly the wrong tool, because it hides the problem. It solves the problem from internal an internal balance point of view, it increases demand, limits by decreasing unemployment, but by doing so, it actually slows down the process of adjustment, because the process of adjustment you want is the adjustment from unemployment to wages to prices and to competitiveness.

So, it seems to solve the problem, but in fact, it makes it worse. I mean, a fiscal policy has been used heavily. You basically prevent the adjustment that you need in terms of relative prices, and I've always felt that it was a fairly important point to make and is very relevant in this context.

So, the question is how has this played out in the Eurozone over the last 10 or so years, and this is a graph which looks like it has been an amazing success. You basically have three countries there, so the green one at the top is Spain, the one in the middle is Portugal in red, and then the blue one is Greece. And they start from current account of trade balance deficits of about six to more than 10 percent. And as you can see, they now, all three of them, have either current account surpluses or basically current account balance in the case of Greece.

So, you know, from that point of view, problem solved. But maybe not. Right? So the issue is, how did this happen? And that's where I've been doing a bit of work, which I'm going to share with you.

So, not only do I not see that, but I don't see that, either, so I have to put my glasses and look at my own slide. But, I want you to get three messages from this table, which I'm going to go through.

The first one is it has taken 10 years and it has been incredibly costly in terms of output and unemployment. So that's the last line, in which the rate of growth in all three countries has been negative. This is the annual growth rate and clearly this has been reflected in very, very high unemployment throughout. So, it hasn't worked very well from that point of view. That's step one.

The second is you can think of the adjustment of a trade balance as coming either from strong exports or smaller imports or a combination of the two. So you can do a decomposition of a trade balance improvement between exports, volume, import volume, and then the adjustment of relative prices. So this is what is done in this table, so you have the first two lines show you the adjustment in the trade balance between 2007 and 2016. And you can see how enormous that has been. This is the same as the previous picture. This is the adjustment.

Then you can decompose between what came from the changes in the volume of exports and the volume of imports and there the story is actually interesting and different from what I expected to find, which is, it's very different in all three countries. Either way, you may notice that I have left Italy out. It's not because Italy is uninteresting, it's just that it didn't have a very large current account deficit to start. So, these are the three countries which will [inaudible 0:09:18.1] countries from that point of view.

And there you see an extremely different story, which is that in Greece, improvement in exports, has played a very small role. Improvement in the trade balance in Greece at the yearly frequency has been about 1.2 per 8% a year, of which exports basically have accounted only for 0.28%. So, most of the adjustment has come from a very sharp decrease in imports.

If you look at Portugal, it's more mixed, actually more, with more weight on exports. It really has been much more due to the strong exports than to weak imports, although both have played the role.

And then in Spain, even more so, exports basically explain largely what has happened and imports have played relatively small role.

So, it's interesting, there are differences between the three countries, but what is striking is that at least the import compression, if you want to think of this way, but decreasing import has played a role, a major role in Greece, much less overall in the other countries.

The third point I want to make in the slide, which is not central, but I want to come back to it, is the way you would have thought this would happen would be by basically making the price of exports lower, relative to the price of imports. That's how you basically improve a trade balance. And this hasn't happened, which has led to the extent that there has been a [inaudible 0:10:59.2] growth even in a country like Portugal. It has not come with a dramatic decrease in the relative price of exports vis-a-vis imports. So the standard mechanism, which we have in mind, doesn't seem to have been central to what has happened.

So these are the three conclusions. Very strong cost clearly in terms of output. Second, quite different adjustment in terms of the role of imports and export, and the third is the mechanism seems a bit unusual.

So let me focus on the role of import compression, which clearly is a dominant factor, for example, for a country like Greece. Now when we use the word import compression, having in mind that this relates to the effect that output has been very weak and therefore imports have been very weak. We tend to think of this as having a very negative connotation and basically the way you have adjusted is by having a sharp recession or depression. Your imports have come down, but it's really not a way to get back to health.

It's a bit more complex if you think that part of the decrease in output was due to the fact that these economies were initially booming, so actually there was too much output and therefore too much import, so that's some of the adjustments in imports is actually not bad, it just reflects the fact that output has returned to something else, or has decreased relative to where it was.

So, what I've done here is adjust the trade balances for the output gap. So if you look, for example, at Greece, the output gap in 2007 estimated, not estimated, assessed by the IMF today in 2016 was 9.4%. Right. Today the output gap assessed by the IMF is -12.9%. So, this gives the image of a country which was basically operating at too high a level of activity and therefore, too high a level of imports, so that some of the import decrease is actually reflecting the decrease in output from the growth potential to potential.

So I do the same thing for the other countries and the last two numbers, I think, are the numbers that one wants to think about, which is the output gap adjusted trade balance adjustment between 2007 and 2016. So let's go from right to left for a change, so in Spain, the output gap adjusted trade balance in 2007 was 6%. Right. So there was a

problem with the trade balance. Today basically the output gap adjusted trade balance is more or less zero, which means Spain has more or less solved its problem of trade balance, adjusting for the changing in output.

But if you look at Greece, to take, Portugal is in between, but if you look at Greece, you see how little progress there has been, which is when the trade balance output gap adjusted was 8.5%, negative, in 2007, it is still 6.2% minus today. And that reflects the fact that although they have apparently a balanced trade, none of it is due to effect that output is 12% below potential. And therefore, imports are very low.

So, the conclusion is the adjustment has taken place in Spain. There was an increase in exports and a decrease in imports was [inaudible 0:14:31.5]. In Portugal, it has largely adjusted from 6.7 to 2. This is better news actually than the line that Adam had earlier about Portugal. Portugal has genuinely adjusted. It took a long time, but it has. It's still not there, but what is very worrisome clearly is that in Greece there has been basically no adjustment on the external front and this is not going to be solved by a program such as the IMF program in some obvious way.

So, let me then move on and make a few more remarks and then conclude.

These are kind of two, two warning slides. The first one is the adjustment for output gaps depends very much on whether we know what an output gap actually is. And I want to show what has happened, for example, for Greece.

So the first one gives you the upward gap in 2007 as assessed by the IMF in 2007. Basically things were just fine. The output gap in 2007 assessed as of 2016 is as you saw from the previous slide 9.4%. So the IMF, now looking back, things that Greece basically had enormous boom. And has revised its views. So the question is why has it revised its views as [inaudible 0:16:10.2] because we've learned about what happened after, this makes us reconsider what we assess, or maybe for political reasons, which is that if you actually thought that the output gap was 0.7% then, then to date, it would be quite dramatically large.

So there is an issue here, and I mentioned this because I'm not sure that the output gap which I used today, which basically shows small output gaps are right, if they are larger then they still have more of a problem left. This is a general remark about output gaps, but they come in right there.

The second warning slide is about what I mentioned is the third point earlier, which is that the adjustment has taken place in strange ways. And I think that we have to understand much better what happened, which is that the standard way would be again, that would be low nominal wage growth less than productivities, so competitiveness would increase. This would decrease the relative price, this would decrease the price, which would decrease the relative price, which would lead to more export. And basically this is not what has happened.

If you look first, the first figure is that when you go through a very bad slump as a result of your lack of competitiveness, then your productivity growth declines a lot, so it's more extreme in the case of Greece. But as you can see, productivity growth in Portugal has been only 0.5%. It has been stronger in Spain for reasons we can discuss later in the panel if you want.

So with that you need a very large slowdown in nominal wages in order to improve competitiveness because your productivity growth is too small, then you have to have wage growth even below that. And as you can see, wages actually have grown very little. This is nominal wages. So in Greece they actually have decreased more than productivity growth and in the other countries, they really haven't increased very much. These are nominal rates of growth again.

So let's step to [inaudible 0:18:15.6] it’s still very painful, given the low productivity growth, if you use the first two, you get the effect on unique labor cost and you can see that, again, these are nominal terms, that have indeed remained very, very low in terms of rate of growth. Indeed, labor costs have been flat in nominal terms. So that relative to the other countries, say the Germany's and the France of the Eurozone, they have decreased quite substantially.

The last twist is that what has not happened is that this slow growth in unit labor costs has not been reflected in the same low growth of GDP deflator or export prices, I give you a GDP deflator. So, as workers basically have accepted very low wages, that prices have not reflected this, what has happened is the margins basically have increased. The labor share has decreased. The profit margins have increased.

This is probably what's behind the export growth in the sense that usual mechanism which is lower prices, more demand, is not the one. It is lower wages, same prices, larger profits, supply response of exports because now your profits are high on the export market.

It's a very different mechanism and one which we have to think more about. It is marginal relative to the main theme of what I'm talking about, but it is sufficiently striking that we have to think about the implications. So let me now kind of go back to the bigger issues.

So first set of bullets is conclusions about what I showed you. Very costly, very painful, very long. It has worked. The pain in Spain was worth it. Probably in Portugal as I have argued, but totally not in Greece. There's been very little progress in that margin. And note that more general fiscal would probably not have solved the problem. Actually it might have decreased the pressure on wages in Greece. So even if we had a fiscal union, it might have more or less the same story.

Now the question is, given that this is supposed to be about, you know, ways to improve the Eurozone, I feel that we have to think about what can be done. So what should one conclude?

One, first conclusion is maybe the shocks which the Eurozone went through will not happen again. That basically there was this normal shock in the sense of a very large decrease in interest rates in those countries which led to [inaudible 0:20:49.6] boom, a credit boom and maybe we're just never going to see this on the same scale and therefore, we may not need that type of adjustment. I'm going to be skeptical. I don't think we'll see that one, but we may well see something else.

I think the second one and maybe the main one for this morning that maybe I should call this labor union with a big U to compare it to the fiscal union and the banking union, that the only way to avoid these vague paid for adjustments is basically to convince the workers and the firms that wages and prices have to either decrease or at least go slowly, and that requires good labor relations, which unfortunately in these countries was just not there.

My own experience in Portugal was to try 10 years ago to convince them to do it and I did not succeed. It would have taken much more than me, but it scary that the labor relations were not good enough. It seems to be that without good labor relations, the adjustment is always going to be very, very tough.

Now something which has made it even harder, is that Euro inflation was very low. So the only way to actually gain competitiveness was to have even no inflation, or even deflation. And having deflation is not only very difficult politically, but it is also dangerous in terms of real debt and other effects that we think about.

So, it's clear that having high average inflation in general would have facilitated this adjustment.

The last two lines is where I am. The Eurozone will never work very well even if we fully do the fiscal union and the banking union, because I'm not optimistic that labor relations will ever get to such a nirvana that these adjustments will take place easily.

But the last point is one thing that every time you criticize the Euro, you have to say, which is that getting out of the Euro creates, you know, this is the [inaudible 0:22:52.6] so than before and we would see them after. So, it's a choice between two systems, none of them, none of the two being ideal. But again, when you think about fiscal and banking union, we have to think that that part is also part of the problem. So let me stop here. Thank you.

Jérémie Cohen-Setton: All right, thank you very much. I hope my talk is going to be a little bit more optimistic than that of Olivier. I think there is some hope along that dimension.

I'm going to talk about the history of risk sharing arrangements between central banks of the monetary union and I'm going to focus on the Federal Reserve system and the Eurosystem.

And I'm going to start right at the beginning of the Federal Reserve system when it was established by the Federal Reserve Act of 1913 and what we tend to forget is that initially the system was very decentralized and in particular, each Federal Reserve bank conducted its own monetary operations. It could conduct its own open market purchases and sales. It had its own discount policy. But for what matters today, it also had to hold its own gold reserves. Okay?

So the US was in the gold standard, but not only had the Federal Reserve system as a whole have to have gold in sufficient quantity against the liabilities of the system, but each regional reserve bank had to do so. And so, in particular, section 16 of the Federal Reserve act required every Federal Reserve bank to hold 35% of gold, but against its deposit liabilities and 40% of gold against its notes.

Now, what would happen if a reserve bank ended up with gold holdings that fell short of these minimums? Well, in that case, it could no longer settle with other regional reserve banks and if that regional reserve bank could no longer settle, then commercial banks in that district could no longer maintain business relations with other districts.

So checks and payments from that district might then trade at a discount [inaudible 0:26:22.9]. So in other words, a dollar from the districts that has a shortage of gold could trade at the discount with a dollar from another district and thereby violating the spirit of the [inaudible 0:26:43.0] enclosed in the Federal Reserve Act.

Now, that did not happen and so the question was what were the adjustments that prevented this from happening? Now there was one type of adjustment that a regional reserve bank could implement by itself, which was to reduce its lending and so therefore decrease its liabilities so that the reserve ratio would go up above the minimum level.

Now that would obviously have been very disruptive for the banks and for the economy of that district. Now, the adjustment that in fact took place was through the pooling of gold reserves between the regional reserve banks. Now the way it would happen is that if a central bank had gold reserves that would go below the minimum threshold, they would rediscount [inaudible 0:28:05.5] with another regional reserve bank and so this way their reserve ratio would go up and the reserve ratio of the other bank would go down. It could also be done through intra-district purchases of bankers' acceptances, but to my knowledge, that wasn't done very much.

And so that was basically the process. Now the question is how did it work? And most of the time, it worked fine. And the contemporaries noted that there had been the spirit of collaboration that had developed of because of World War I and that every time a Federal Reserve bank was requesting of a discount, it was accepted by the other bank.

So that was at least the official line that you would read in the annual reports of the Federal Reserve. Now that we have access to archives, we start to see that, you know, that process wasn't always that smooth.

So for example, recently we've discovered that there was a pretty intense conflict between the Atlanta Fed and the Cleveland Fed in 1920, so the Atlanta district had been particularly badly affected by the decline in the price of cotton and so many of the banks were affected by that. And so, Atlanta requested rediscounting for quite a long period during that time and it was the Cleveland Fed that was providing that liquidity, and the Cleveland Fed was complaining to the board that Atlanta was too lenient and that it has to decrease the size of its balance sheet.

But the case that I want to spend a little bit of time on is, is March 1933, which is when the system of collaboration basically broke down.

So, here you have a picture from a paper by [inaudible 0:30:44.3] that show you the gold reserves between the beginning of February and the end of March in 1933. The top panel shows you the reserve for the Federal Reserve Bank of New York and the bottom panel shows you the reserves, the gold reserves for the federal system as a whole.

So, following the bank holiday in the state of Michigan, there had been a lot of stress and deposit withdrawals, but the Federal Reserve Bank of New York was, in addition, facing a drain on gold because there were expectations of devaluations of the dollars. And so what you see is that between the first of February and March 4th, the gold reserves of the New York Fed decreased by 60%.

And so at that time, its gold reserve ratio would have been at 25%, so below the threshold. Now, what you can see as well, is that in principal, the system had about 3 billion dollars of gold reserves available and so the system could have provided for that shortage of gold in New York, the reserve ratio for the system never fell below 45%.

But the cooperation broke down. Basically on March 3rd, the Federal Reserve of Chicago refused to rediscount 100 million dollars of government securities from the New York Fed. And the board refused to invoke its authority to require that in this intra-district rediscounting. This led the New York Fed to ask for the closing of the banking system in New York, in the state of New York, which then led to a nationwide bank holiday.

And so, then the vertical line 4 shows you basically the time when the banks reopened. And so the first question was, okay, what were the emergency measures that were taken so that when the banks would be open, they would not be faced with those deposit withdrawals? I think one, there were two elements there. One was to weaken the link between the gold and the issuance of notes. And the second thing was to allay the concerns of Federal Reserve banks about credit risk. And so basically to have the backup of the fiscal authority.

Now I think the more interesting aspect is the more medium term reforms that followed from that episode. And the system had serious repercussions on the Federal Reserve system. Basically it made two changes. One is that it made the mutualization of risk more automatic and second that it reduced the autonomy of the Federal Reserve banks.

So this is a time when open market operations became [inaudible 0:34:46.2] for conducting monetary policy and so the system open market account, which is the joint account through which open market

operations are executed, in fact took center stage as the principle means for sharing gold reserves. And so what you see here are basically regulations and directives that basically showed how the allocation of purchases should be made so that the reserve ratios would always be above the minimum thresholds.

And, in fact, interestingly, this is at the time where the Federal Reserve stops publishing reserve ratio by regional reserve banks because they are no longer meaningful because they are always equalized.

The other leg of that reform was basically a decrease in the autonomy of the Federal Reserve banks.

And so, now let me turn to Europe. So here, I think we've seen a process where we get more mutualization, less autonomy, and I think the thing that worries me a little bit in the case of Europe is that throughout the crisis we've seen more restrictions on that mutualization of risk. So, a lot of us have seen that and noticed that on the different forms of QE, so initially the phrase vintages of asset purchases, large asset purchases, have full risk sharing, whereas the last one doesn't.

But this is actually broader than just for asset purchases. This is true also for the collateral framework, so basically we had a convergence over time towards a single list with full mutualization and some relaxation of that collateral framework in 2011 was accompanied by a reduction in sharing.

We also see that, de facto, so here it's not an increase in restrictions on risk sharing, but emergency liquidity assistance has taken an increasing role in providing liquidity during the crisis. And here the rules of emergency liquidity and assistance are such that the risk remains on the balance sheet of the national central banks.

So, the question then is does it all matter? Does it create some kind of vicious loop between the balance sheet of the national central bank and the balance sheet of the rest of the economy? And one could argue that it doesn't really matter. Either because if the sovereign is not bankrupt, you could recap the national central bank. Or if the sovereign is bankrupt, another entity could potentially be capped, the national central bank in the case of large losses.

Another response would be to say actually there's nothing in the treaties or in the status that requires Central Bank to have positive equity and so this may not be an issue. But all of those things are not problems as long as, you know, there are no restrictions on target

balances, that there are no restrictions on the provision of liquidity through ELA, and you know, I think that's what makes it a little bit worrying. Is that there are many scenarios one can think of where there would be restrictions following those big losses. Thank you.

Nicolas Véron: Thank you and as Adam suggested, I will take the financial system side of this actually to not be only about banking union, but what is called here financial union, which is way to say that given the progress made on banking union, given breaks, they've given a number of ongoing developments, it is because our session today is forward looking and looking at the big challenges, the big picture of EU of policy making following the French election and all that, actually banking union is only part of a broader policy program, which should be about the single market for financial services.

And indeed, banking in Europe is a big part of the financial sector, but it's only one part of the financial sector and banking union can be viewed, even though it's not been sold that way, as a single market project. It's been a way to eliminate national distortions in the single market for banking services, starting from the Eurozone, but actually was an ambition for the entire EU, especially in the current or forward looking perimeter of EU27.

So basically, if you look realistically at the financial services policy challenges going forward, the big picture of EU is that banking union even the more complete banking union is not enough. There is a need to think in terms of the entire financial system.

So where are we now? We have a transformation of moving from national and financial systems to European financial system and it is, it has made important steps in recent times, but that's unfinished. So history of European nations, of course, is a history of national financial systems where the financial system was very much leveraged to the benefit of the State and to national government through various means, such what the economists broadly speaking and in bit of an imprecise vocabulary called financial repression, and God knows we've had a lot of financial repression in the history of the different member states.

Now the EU and the European commission in particular, are, as it is its mandate, has acted to gradually create a single market and has done so particularly since the 90s in terms of single market legislation and regulation in the whole area of financial services, not only banking, but capital markets insurance, asset management and the like.

Importantly this was limited to laws and rules and regulations, not to supervision and crisis management mechanisms. And what we have

learned through the crisis and that's the third bullet point, is that actually you cannot build a single market just with rules and regulations because what is important in terms of perceptions of the economic agents and investors is how will authorities act in a crisis and that has been the whole story of the bank sovereign vicious circle.

Interestingly the bank sovereign vicious circle has become a standard way of reading the Eurozone crisis, but it hadn't been predicted as such by anybody. There is no literature before 2009 on the bank sovereign vicious circle. So contrary to other weaknesses of the Eurozone, this is not something that people had told you about. This is something that really emerged empirically from the observation of the crisis. And as many of you remember, it's been a very powerful contagion mechanism particularly in the dog days of the second half of 2011 and the first half of 2012.

So banking union was a response to this challenge, and to put a long story short, when you have the bank sovereign vicious circle you can address it by either a fiscal union or banking union or both. And fiscal union was tried and failed and basically it left banking union as the only way to save the Eurozone in mid-2012.

So we had a decision to do a European banking supervision, but also a broader decision to integrate the crisis management framework and for now the one piece in which this has been implemented is the resolution framework which has been into force a little bit more than a year. I will come back to this.

So basically in banking, you now have a framework where it's not just regulation, but it's also supervision and crisis management, but without the full package as I will come back in a minute.

Capital markets union is for all the non-banking stuff, very logical follow up to banking union, which had been announced and developed by the commission since mid-2014, but so far there has been more talk than action for reasons that have to do with the UK and which means that it's almost not started, if you think of these echelons of supervision and crisis management as opposed to the regulatory stuff, rules and laws, where there is a lot of integration that started before the crisis.

So this is an illustration of what I said about banking union. I think it's now accepted conventional wisdom that the mid-2012 decision to go for banking union was a turning point of the crisis. It was an enabler of ONT, of course, a market impactful measure of [inaudible 0:44:40.0] supervision but without the decision to go for banking supervision, there is increasing evidence including a direct anecdotal evidence from

what the key players have said that this was the turning point. And it led to a very orderly de-escalation of the crisis after mid-2012.

It's interesting here to see Italy going up again in recent months and this echoes some of the things we discussed about this morning. Maybe we'll come back to it in the Q&A, but I think it's also important to note that this increase in yields and spreads in Italy is much more orderly than what you saw in the initial phase of the crisis on the left hand side of that chart.

So where are we now in terms of this framework? Does banking union work? The answer is yes but not to the full extent that it was desired. There is a very structural shift here and it's a shift not only in terms of the supervisory and resolution framework, but actually in the whole political economy of banking in Europe and God knows the political economy is important, so I think it's still early days. Right? It would be naïve to say the full set of objectives could be reached after just two, three years of implementation. So it is absolutely normal that we haven't completed the transition to a fully European non-national banking system.

So the first piece that has been put in place is supervision by the ECB and I think most people who really look at that agree that there have been remarkable achievements there in terms of the quality of ECB supervision, first in terms of operational success of the transition, which has been pretty orderly, and on time. But also in the fact that ECB supervision is to use their own vocabulary, "Tougher and fairer" than anything that existed before at the national level.

So we have had higher standards and of course we can say they are not high enough, but they are higher than what existed before, essentially in every single member State, not just on average. Which, per se, is a remarkable achievement.

Now there are pockets of weaknesses, of course, in the Eurozone banking system. I think they are being addressed by the ECB at the pace which many of us find too slow, but gradually it makes a huge difference. And to oversimplify, I think it's also fair to say Greece was at the [inaudible 0:46:50.4] in 2015 and the broader package of the Greek crisis then. Portugal has been, in my view, very successfully addressed by the ECB and a bit stealthily, in the course of 2016, actually is the reason why I'm less pessimistic than Adam on Portugal is, it's because of the banking aspect, which I think has been, has made a lot of progress, which hasn't been fully recognized until now.

And you won't be surprised to see me cautiously optimistic that the same is happening in Italy. I think the key point in Italy was the differentiation last December between Unicredit and Monte dei Paschi. The demonstration by Unicredit that there was no limits to market access for banks that could retain at the bank specific level, irrespective of national developments including the referendum, could retain credibility with investors.

And the fact that the ECB was able also to put the end of the game to call the end of the game on Unicredit by triggering what is going to happen later this year in terms of precautionary recapitalization by the government, which means nationalization. I think that was an important point of differentiation, and as Adam would call it, and me, too, a triage in the system.

So I think there are lots of unresolved problems still in Italy. We can discuss them in the Q&A, but the big picture is that this is being solved, even if the pace of resolution is frustratingly slow.

So resolution model, however, is still untested, and to put a long story short again, we have bailing for junior debt, but not senior debt and that's not enough if we want to have credible crisis management.

So in conclusion of this slide, bank sovereign linkages persist. They haven't been eliminated; they take many different forms, also in terms of the governance of the banks. We have a publication here at the Institute in the next few days on this and this frames the equation.

Now, Brexit comes on top of all that and it also makes a difference between because London is undisputed trade, financial hub of Europe in terms of wholesale finance. So here the tradeoff is between interdependence and relocation. It's good to have interdependence. There are benefits, economic benefits of cross-channel integration, but at the same time, in terms of financial stability, there won't be an alignment of interest between the ECB and the Bank of England going forward.

Everybody wants an orderly transition, but it's pretty clear that the future landscape cannot be just an extension of the current one. And basically a way to look at it is that EU28 was a hub and spokes, with the UK as the hub and all the other countries as its spokes.

So EU27 has to be a more distributed network where you don't have a single country, even Germany, cannot be as strong a hub as centralized as the UK was and therefore it raises the question of the consistency of supervisory practices in different member States in ways that didn't

exist in the EU28 situation. So this adds urgency to the debate on supervisory architecture and supervisory arbitrage, which was sort of suppressed in the previous phase of discussion, especially about capital markets union.

So let me move to the conclusion which is what is a vision that should underpin the next steps of policy discussion and reform? The vision should be a single financial system. There is no point any more in defending closed national financial systems in terms of the Eurozone, what it has become already, with monetary union and half-hearted banking union.

And for once there is no tradeoff here between stability and efficiency. This is familiar tradeoff in financial regulation. Normally financial stability goes one way, efficiency the other way. Here we don't have it. Fuller integration is good, both for stability, reducing the linkages, enhancing shock absorption capability, and for efficiency by minimizing friction.

So, we also have the banking union as a proof of concept and therefore we know it's possible to have full institutional integration if the political will is there. We know that it can be made to work and actually proof of concept has been going more smoothly than many people anticipated in terms of building up the supervisory capacity of the ECB.

So what does that mean in practice? And that's my last slide. What are the next steps? There's an immediate post Brexit agenda, which is about the relocation of the European banking authorities, or EBA, and stuff about financial infrastructure, central counterparties, also known as clearinghouses. This is very contentious politically, but in a way is just specific segments compared to the broader agenda I'm talking about.

In terms of the broader agenda, there is the capital market side and the banking side, and the capital market side is basically about empowering the European securities and markets authority to make it into a combination of what in the US would be the SCC and the CFTC. And there's a lot to be done here, but it has to be started, and it has to start with an overhaul of its governance and funding to make it a credible supervisor, which then can have more authority on things like accounting, auditing and other capital market issues going forward.

And in terms of banking union, we discussed that previously in other sessions, but there is a need to move from what you could call the hard banking union, [inaudible 0:51:54.3] money curse three years ago, to

what wouldn't be a full banking union in the absence of fiscal union, connecting with the debate this morning, but something like a three-quarters banking union, sort of tongue in cheek, where you would have more debts, more integration without having the full package of a single State to echo Adam's remarks this morning.

And this has to do with sovereign exposure limits, which is part of the discussion that Jérémie introduced, with further risk carrying with European deposit insurance, European deposit insurance scheme proposed by the European commission, bank recognition by the ESM, back stops, et cetera, and further harmonization in [inaudible 0:52:32.9] but also in banking solvency and maybe going forward with a longer term horizon in the taxation of banking, so that you would get [inaudible 0:52:42.0] single market. Thank you very much.

Adam Posen: Thank you Nicolas, thank you Jérémie, thank you Olivier. Even if there was good news on Portugal buried in there somewhere, the move from the sort of visionary Jacob, Jeromin and myself on what you could spend on money to Nicolas, Jérémie and Olivier on how hard it is to make financial and monetary systems work is a good wake up call.

I could ask questions but we have a good audience and so I will not hog the mic. As ever, we have a traveling mic up front in Jessica's hand, we have a standing mic at the back. Please identify yourself when asking a question or making a comment. Otherwise, you will force me to talk, which would be bad. Please. Can you -- it would be faster if you can go to the back mic. Thank you. You don't have to run.

Speaker: Thank you very much for really an interesting panel. I want to take up Olivier Blanchard's invitation to ask you, to ask you please to expand a little bit on the differences in the productivity figures that you mention and you showed us, as between Spain and Greece and Portugal, and the reasons behind this, and what that implies for long-run growth prospects in the three countries.

Olivier Blanchard: It is still a lovely mystery why productivity growth has done what it has done in the three countries. I have started doing work with [inaudible 0:54:56.2] on Portugal and have seen some work on Spain. It looks as if financial crises do strange things to productivity and they destroy good firms because they just happen to have a lot of debt and cannot pay it.

And that decreases productivity, but in many cases, they also seem to force firms to take decisions that they would not have taken otherwise, and when you are very short on cash, you think harder about whether

you need all the workers that you have. And it's very clear that much of the increase in productivity growth in Spain in particular comes from the need to adjust to a very tough environment. Very limited credit and firms basically saw a decreasing output in normal times, it would have done some later holding and therefore productivity growth would have looked dismal. In fact, they were forced to get rid of a whole lot of workers, so a lot of productivity growth came from firms being forced to do it. That's good news in terms of a one-time adjustment. It's not very good news in terms of continuing to have high productivity growth in the future.

Adam Posen: Yes, there, no, Jeromin, you're up front.

Jeromin Zettelmeyer: So a couple of questions also for Olivier. So, to what extent does your finding at the end, which is that differences in export performances can be explained by changes in profitability, even when there is no change in relative product prices. To what extent does this negate your kind of assumption at the beginning that a currency union can only work if there are such internal price flexibility things and you know, given your conclusion, should we actually be pessimistic or should we be optimistic? Because you know, there are many ways you can become more profitable.

And just quickly before you answer, I also thought that your story wasn't quite so clear for the case of Spain, because on the first slide, you showed that there were actually, you know, export prices had declined compared to import prices. And that seems to be the main success story. So, I'm not sure: (A) Whether your main conclusion actually is borne out by your result on Spain and second, whether if it's true, well, it sort of, your whole framework collapses for what a currency union should be about.

Olivier Blanchard: Jeromin, the whole framework just collapses. No, there are two ways in which we can think of an [inaudible 0:57:50.2] adjustment. Both have lower nominal wages to start, or higher productivity, one of the other two. Then that's where you can go one way or the other. The first one is your price maker and you have a fixed markup and therefore you will flag for lower wages and you increase demand. Which is what we teach in textbooks and we think is a dominant adjustment. That just doesn't seem to be the case.

The other case is your price taker. Well you can take the price in the defined market as given, so that in this case, you're not going to change your price, you're just [inaudible 0:58:27.0] larger margins, in which case the channel is not through the direct increase in demand, because your price hasn't changed, but by the fact that you now make

more profit, you're probably going to invest more and export more. It comes from the supply side. But in both cases, what is absolutely essential is that there be nominal wage adjustment.

There are differences in terms of distribution, which is in one case the low wages were just much less than in the first case. In all cases, real wages in terms of a CPI will have to decrease. This is what a depreciation is. But if it, in the case in which the prices don't change and the nominal wages go down, then the effect on wages, real wages, is even stronger. This in turn has effect on domestic demand, but no. Where I may have been misleading is in calling these relative price adjustments. Because that's not what's needed, is relative cost adjustment, if you want. So I think, yes, the semantics, is wrong.

Your other point was -

Jeromin Zettelmeyer: [Inaudible 0:59:34.7] Spain you see export prices falling more than import prices. There was one slide -

Olivier Blanchard: Yes, so but it's true. I mean, so it goes the wrong way into other countries and the right way in Spain. But it is still the case that mark-ups have increased in Spain. Or another way of saying this, the labor share has decreased in Spain in all three cases.

Adam Posen: At the back please, and then Jacob.

Peter Sturm: Thank you. I'm a retired OECD official. And it seems to me that much of the muted optimism I hear about Europe's future is based on an invigoration of French/German corporation. And the obstacle is in the way for this to translate into real success on the German side is reluctance to agree to more fiscal and monetary integration, and we have talked a lot about this. On the French side, it seems to me the major obstacle is successful structure reform by the new French government, and I have a hunch, based on some statements in Berlin, that German willingness to make concessions is partly based on success in France to implement the necessary reforms.

Now I would like the panel to comment on the probability of the new President and Prime Minister in France to implement these required reforms and overcome opposition from the left, especially the unions, and given Mr. Blanchard's presentation, I wonder whether the optimism that seems to prevail is justified.

Adam Posen: Thank you, we have three French people here, but we have one who actually has spoken to the second coming, maybe he can start.

Olivier Blanchard: So, two parts, I think the strategy is Monsieur Macron is not to push very hard on Europe issues until late in the fall. Two reasons, the first one is the German elections. He doesn't want to complicate the task of Madame Merkel. The other is that he indeed wants to show, and because he also cares very much about this, that he can do serious reforms of the labor market in France. And so, on the assumption that he's able to get some reforms passed by mid fall, and that the elections have taken place in Germany, then I think that there'll be more serious discussion, because then the Germans will be convinced that Macron understands economics and what needs to be done.

Now on whether he will succeed or not, you know, that, I'm going to repeat things that you've heard, the first one is parliamentary elections. It will make it easier if he has his own majority. He doesn't absolutely need it, but will make things much easier. He will then, this summer, work on the reform of the labor law. He will present it in the fall and people will go in the street. And then the question is does he have enough of a mandate to basically wait them out for a number of days or not.

This is the story of reforms in France. The difference this time is that he has been elected on the program which was explicit about what he wanted to do, and if he has a strong majority, clearly can wait a bit before giving up if he needs to. So, these are the two parts to my answer.

Adam Posen: Nikolas, Jérémie?

Nicolas Véron: Yeah, I completely agree with the way Olivier framed it. I would add maybe two things. And obviously the key issue is the parliamentary election result and we won't know that until June 18, but on Macron himself, and assuming he has the means to govern, depending on which parliament is elected, he has a track record on structural reform, specifically; this is basically how he has built up his own political identify.

So legislation that he pushed in both product market reform and labor market reform has been very contentious. He hasn't achieved everything he wanted to do as a Minister, but that's basically what he's known for. So there is no question that when people voted to elect him, of course some of them voted against Le Pen and that's a game, but to the extent he has a mandate, it's really about that.

The other point extends in the way a different part of your question, which is why is that this hasn't happened before in France and I think there are, was until now, at least in the last 20 years or so, not going

back to the Mitterrand years, but there was very ambiguous attitude to European integration in France. France has always been on both sides, right? Very pro EU rhetorically, but also very sovereignist on core areas of policy and you see that in economic policies, in the banking sector, in the banking unions, things like that, and you see that in foreign affairs.

Macron is more genuinely pro EU and willing to evolve or pool sovereignty at a new level than any President since at least Mitterrand and possibly any President in the Fifth Republic. And I think there is every indication that this is really what he believes. If you're cynical you can say he has a long career ahead of himself if he wants a bigger job than French President at some point in the future, maybe. So, he is willing to create more ability for executive decision making at the European level than Sertan Sarkozy was, than Hollande was for different reasons than [inaudible 1:05:42.2] was and I think that should make a difference going forward as well.

Adam Posen: Jérémie, do you have anything to add?

Jérémie Cohen-Setton: I think one point that may change the usual dynamic about structural reform is the fact that he actually not only comes with a package that has structural reforms, but also has the intent of changing the way the security of policies work, right? So it's more like a move towards flex security rather than just more flexibility, at least that's the way he has framed it, and so, then what that means is that in terms of the sequencing of those ingredients in Euro reform, maybe there is a little bit more scope to build confidence, either by, you know, bringing some of the security ahead of the flexibility or the two together at the same time, so that you really change parameters of the game rather than just have a repeat of the usual this is just more flexibility.

Adam Posen: We're at our witching hour, but I'll let, oh dear, Jacob and Ted. Jacob, you've already spoken today. So, Ted. You get the last question.

Ted: So I've got to ask a sort of existential question. So I was puzzled in the first panel that you had two speakers who were talking about Europe and one speaker who was talking the Euro area. And those are two different concepts and they have to be reconciled, and then thinking about Jérémie's remarks and Olivier's, so exactly why do we worry about the balance of Spain and the balance of trade or Portugal in the Euro area context, right? When we don't worry about the balance of trade of Alabama in the US context.

Olivier Blanchard: This was a question which was asked in 2007 and which was answered a bit later. Do I need to explain? This has been called sudden stop, it can happen in economy such as the Eurozone. It's what we've done.

Nicolas Véron: I think in a way, that's one of the things that were underlying my presentation, but which I probably should have put forward more, is that in principle, if you have a single financial system, you cannot have sudden stops the way we observe them. So, one, the reason why had the crisis the way we had it was the bank sovereign vicious circle, which is way to say the financial sovereign vicious circle in a system where most of the financial system is banks, and really I think it's a good way to read everything that has been done and may be done going forward in terms of financial sector policy as aiming at breaking that connection.

Now, if you have, as I advocated as a guiding vision, a single financial system for the European union, or the Eurozone for that matter, that doesn't know boundaries in terms of policy differences. Of course if there is a recession in Portugal, that's bad for banks which do business in Portugal, but if you don't have a direct financial linkage through the sovereign, you shouldn't have sudden stops. So I think this is a thrust of the policy response and appropriately so, in that where we have to go further than what has already been done in the next reform steps.

Adam Posen: Let me close it there. I will just say in response to Ted's comment, that I do think it is a critical issue that we have not addressed today and which remains to be addressed, that if the Euro survives, which all of us certainly hope and most of us presume, although our speaker tomorrow night may disagree.

If the Euro survives, there is this fundamental tension that written in the treaty everybody, now that the brits are out, everybody except Jacob Staines has to get into the Euro area and in a governance terms, more and more decisions, as you recognize, I'm just pulling out some of your question, more and more decisions will be taken among the Euro group and so the question is do we go from a situation where there are bunch of countries, members, EU members who stay out of the Euro willfully to tumbling in, but if they tumble in, if as, I think it was Olivier suggested, this was sort of a one-time transition for Portugal, Spain, Greece.

Do we need to worry about another round of boom bust one-time transitions for the rest of the EU members who go in the Euro and remembering back to what happened to Mexico after the NAFTA agreement, this is not entirely reassuring. Anyway, something else for

us to talk about. If we're lucky enough to have European integration move forward.

Please join me in thanking our excellent panelists and thank you all for joining us here.