

A CONVERSATION WITH IMF CHIEF ECONOMIST OLIVIER BLANCHARD ON THE GLOBAL OUTLOOK

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VIKRAM NEHRU: OK, I think we should – we should begin. Welcome to all of you and to this afternoon’s discussion on the global economy in 2012. I am Vikram Nehru. I’m a senior associate here at Carnegie and the chair for Southeast Asian studies. And just prior to joining Carnegie I was at the World Bank as the chief economist for East Asia and the Pacific.

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It’ll be my pleasure to today to moderate the discussion and, you know, over the course of the discussion today, what I hope we will be able to cover is what’s happening in the eurozone and what’s happening in the United States and, of course, what’s happening in the emerging markets, particularly China, the world’s second-largest economy and now its largest exporter and manufacturer.

To make sense of all these – what’s happening in all of these regions we have a tremendous panel here. To my left we have Olivier Blanchard, the economic counselor and director for research at the IMF. To my right, Desmond Lachman, who is the resident – who is a resident fellow at the American Enterprise Institute. And to my extreme left, Uri Dadush of the Carnegie Endowment, a senior associate here, and he’s also director for the International Economics Group.

So why don’t we begin then with you, Olivier. Perhaps you can give us a quick – a 10-minute overview of what’s happening in the global economy – (audio break) – take it from there. Thank you.

OLIVIER BLANCHARD: Thank you, Vikram. Good morning or good afternoon. Let me try to give you a sense of how I see the world that – (audio break). Clearly, there has been a number of good news in the very recent past from the effects of the – (audio break) – the problem is, I think many people have gone from being very pessimistic to being very – (audio break) – in the space of a few weeks.

And we are at one of these stages in which we have to assess what is noise and what is news, what is temporary and what’s permanent. And it’s always a very difficult thing to do. I think we have a great tendency to want to believe in good news and think that somehow now things are fine. So I thought what I would do would be to take one step back and see how I see – describe how I see the broad evolutions and then we can come back to more recent events.

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So if I look at advanced countries – and the story today will be largely a story of advanced countries, this is where the action, bad as it is, is – I still see three main breaks which are going to be the – at some – at some level – different levels across different countries for quite a while – for many years to come would be my guess. So let me go through the three of them.

So the first one is saving and deleveraging by households. Now, that's not true in all countries. But it's true in many countries in which the saving rate had considerably declined, and the most obvious case being the case of the United States. And it's clear that it was too low, and that the consumers have to adjust – have to have higher saving. So that saving rate has increased back, but the result of this is that if you think about where – (inaudible) – is going to come from, consumers are going to supply – are going to consume a smaller proportion of our putting something else has to take the slack.

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And what that something else is or will be is not entirely clear. There was some hope that it would be in their exports, but it's not happening. And the question is how – if we want to go back to the same upward trend, what is going to replace the more – now more reasonable U.S. consumers? And that's an issue which is going to be with us in the U.S. for a long time. It is there in some other countries as well. I think the U.S. is probably the best example. So that's one.

The second factor which is also slowing the recovery is fiscal consolidation. And the news in terms of fiscal consolidation is very good in the sense that in nearly all of those countries, with exception of Japan for a very good reason – because of the earthquake – we've seen fiscal consolidation. And there is more fiscal consolidation coming, roughly of the order of 1 percent for the cyclically-adjusted balance across countries, which is quite substantial. Now, that's clearly needed and fiscal consolidation is needed. But in the short run I think there is no ambiguity about the fact that this is not good for demand and this is not good for growth. I think the notion that these fiscal consolidations could be expansionary from the start, if it ever had any credence, has been proven wrong time and time again, country after country. So this is the second factor. And that's not going to go away. We have a very long way to go.

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The third one is deleveraging in the financial system and the degree to which it's going to lead to a credit crunch. And the two are not quite the same. Deleveraging can take the form of setting some assets and not affecting credit directly but selling assets to other banks to reorganize the business model. Here what we worry about from a macro point of view is the degree to which it's going to lead to a credit crunch. And there I think the evidence is not – is not as clear as I would like and a bit uncertain about the degree to which it is happening and the degree to which it will happen. In the U.S., it doesn't seem to be happening on a major scale. The banks had basically indicated that they were loosening tightening standards. In the recent past, they have stabilized. But with a few exceptions, I think that it is not a major issue in the U.S. at this point. Some small and medium-sized enterprises are still very much out of that – of that market of the – don't have the ability to borrow, but it is (not/now ?) getting worse.

The big question is in Europe. And there was a sense that the requirement to have pretty much higher capital ratios as well as some other factors would lead banks to deleverage by reducing the assets rather than increasing their capital. And that would take the form of a major credit crunch. And that's why it's difficult to read the evidence. The

evidence is that in the last three months credit to households and to firms has decreased considerably. So one might say: Wow. That's surely evidence of a credit crunch. But at the same time, activity in Europe, in the euro area, has also declined. And there was negative growth in the fourth quarter of 2011. So you could say, well, it's really not the credit crunch which is there. It's basically the fact that output is low and people don't want to borrow – it would be a credit demand phenomenon.

But you can – you can go a bit further. You can ask banks why credit is lower, and you ask them whether it's because there was low demand or because they tightened. And we have this from bank lending surveys and we had the last one coming out last week. And there the banks indicated they had been – they had been tightening lending standards.

But then, one more step is needed, which is why is it that they did it? And they give you various answers. One could be that they don't have the capital. One could be that they don't have the liquidity. And one could be that they are very worried about the future, just don't want to make loans. And it turns out that the main two answers were liquidity or access to market funds and expectations of bad things in the future, leading them to tighten credit now.

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Now, if this is it, if this – (these ?) you have the two main reasons, then the introduction of LTRO by the central bank will make a difference. Part of the survey was taken after LTRO but it takes a while for these things to work. And if it is – if it is capital, you will be stuck. You have to have more capital. But if it's expectations of the future, this can turn on a dime. It just – you know, just needs optimistic expectations, which lead banks then to be more willing to lend. So it's not – the mechanical constraint in the same sense is capital – is – would be. So the short of it is deleveraging has made – has made the news. It's probably important. But at this stage, it's important for Europe – is I think a(n) answer. So these are the three factors.

Now, they are all the result of legacies of a crisis, and they're all desirable in some way, which is you want households to save enough, you want the budget to get back in shape, you want the banks to become smaller probably and more focused. But in the short run, all this leads to lower aggregate demand and lower demand for goods and less growth.

Now, in a perfect world, the adjustment would happen for the interest rate, which would decrease enough to stimulate investment and other things. But it's not happening because we have the zero lower bound. So all these things which in another environment would be desirable, would lead to low interest rate but growth, are leading to lower aggregate demand. And as long as this zero lower bound is binding, then all these things are going to have an effect on slowing growth.

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So these are the three breaks. Now, if you go around the world, what you see is – oh, well, advanced countries I would say – what you see is that they are in some form in – present in nearly all countries, be it the U.S. or be it Europe or be it elsewhere, but I would

say in chronic form, not intense form. And then what you have in Europe is that you have present in acute form. And that's why Europe is at the center of the crisis, because when they are present in acute form, then the feedback loops, the interactions between these three factors, become that way. You have a fiscal consolidation. It kills growth. Growth creates nonperforming loans. The banks are in trouble. They cut credit. Growth goes down. You have the further fiscal consolidation. And that's the scenario that we see being played in a number of European countries, and that's a very serious issue. This is what leads us to think that some of the growth numbers for some of these countries will be negative and fairly large.

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Let me now turn to the next set of questions, which is clearly the center of the problems in Europe. But what are the spillovers from Europe to the rest of the world? And here you have to kind of answer the question under two conditions, which is if things remain roughly the way they are, which is you have to muddle through European scenario, what are the spillovers that we observe now? Then there's another question, which is suppose things got much worse, and then it's a different type of spillovers. But then we talk about the ones that exist under this kind of muddling-through scenario, and let me start with the U.S.

I think there, again, I may – I may disagree with some; I think there is a sense that the European crisis is having a fairly major effect on the U.S. I'm far from sure that that's the case, because you have various effects at work. You surely have some European banks cutting, decreasing operations in the U.S, but they are not – they normally don't represent much of the lending. You have some spreads, which are higher as a result of the European crisis spread in the U.S. But you have another effect which has been visible and strong, which is the safe haven effect, which is that when things are bad anywhere in the world, but in – in this case in Europe, money tends to come back to the U.S., decreasing the long rate. If you do back-of-the-envelope computations, you might argue that the uncertainty in Europe has decreased the long rate in the U.S. by maybe up to 1 percent. Now, it's true that there are factors upsetting it – some spreads have gone up – but on net, for the moment, it's not clear to me that the effect of the European crisis on the U.S. is that major. Again, the big caveat is if things got much worse, then we would be in a different type of correlations and spillovers.

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On the effects of Europe on emerging markets, there I think you can't put all of them in the same basket. You have to be careful. There is a set of emerging market countries which is clearly suffering, and will suffer more is my guess, which is emerging market Europe – so Central Europe, Eastern Europe. They're affected by trade, because they are very much connected to the euro. And they're affected financially because Europe banks, when they want to deleverage or decrease credit, are told by their governments not to do it at home. And then they look for the easiest place to do it, which is next door. And so these countries are clearly suffering from that.

If you leave emerging-market Europe aside, then the effects are, again, more complex than some think. I mean, on the trade side, no question that the slowdown is

decreasing the European imports, and therefore has an effect on EM (ph) exports. That's the (evidence ?) visible. But on the financial side, it's not completely obvious, because you have this interesting tension or fight between two factors. The first one is risk appetite, which tends to make – you know, when there's a decrease in risk appetite, money tends to flow out of emerging market countries. That's a natural tendency. But at the same time, you have the relative attractiveness of emerging market countries in terms of returns, relative to Europe or even the U.S. To give you an example at this stage, if you go to Chile and you buy bonds, you'll get 6 percent. And I would guess that you're more likely to see an appreciation than a depreciation.

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So you have these two factors, and depending on which one wins, capital flows in or flows out. My best guess is that it will mostly flow in for the time being. Again, this is in the muddle-through scenario. Again, the worse one is more complex. That's clearly the evidence of the last few months. I mean, if you look at inflows into emerging market bond or emerging market equity funds, they are running at a very high rate. Last month was actually the highest in many years. I don't think we can count on it as continuing forever. I think there's going to be enormous volatility so that the problems of emerging-market countries is going to be hard to handle than volatility, a bit in the same way as they did – they had to in 2009, in 2010.

OK. Let me come to the bottom lines, because I probably have used my 10 minutes. Forecasts. So the question is when you do a forecast, what assumptions do you make about policy? So what – our forecast, the one which came out in the – in the WEO update a few weeks back, was based on a slow resolution of the European – of the euro crisis so that things would be done, but not quite as fast as some would dream, but faster than some would fear; and that spreads would slowly decline over time – (inaudible).

And based on this, we had a recession in Europe in 2012 – small. And we had, you know, point estimate as these – as these things go very imprecise, but minus .5 percent. I would say that's probably where the news of the last few weeks, the introduction of the LTRO and its apparent effects and then some news on the PMIs and the confidence indicators would lead me to not be terribly surprised if we had in fact a weak recovery, so something on the positive side, not very far from zero, but positive. There was almost surely negative growth in the last quarter of last year. So it take – technically it would just take another quarter to have a recession – it might be. But it's going to be close.

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For the U.S., we had 1.8 percent for 2012. Again, in the light of various news, I'd be willing to go a bit higher. We haven't done it formally. But if I had to take a guess, maybe I would – I would get closer to 2 (percent) or just a bit above. Now, that's good news. But one should remember that that's not good enough in the sense that if, for example, you wanted unemployment – the unemployment rate to be down to, say, 6 percent in two years – reasonable goal – you need 4.5 percent growth each of these two years. So you know, it's better than it could have been, but it's not – it's not – it's not – it's not great.

And then for the emerging markets, we – in the WEO update, we had a slight decrease in the growth rate relative to 2011 partly because of lower trade, partly because of internal reasons – idiosyncratic, I think, in India and Brazil. We had slightly lower growth in China, but we did not predict a hard landing at all. So our numbers are, you know, very high, as they always are for these countries, but just a bit lower than last year.

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I think the last point is, well, what if there's an "event," quote-unquote, in Europe – I don't want to be too specific about what the event might be, but you can think of some – there I think that we would see a fairly large increase in uncertainty. I mean, basically whatever that you think of, the assessing balance sheet will be difficult for various banks, for various (place ?). And so this would definitely increase uncertainty and possibly lead to very large spreads on a number of sovereign bonds, and that's very important that we have the means to maintain low interest rates.

That's where the firewalls discussion comes in. Will the firewalls be in place? There's clearly much progress, although we may come back to it. We're not quite there yet. And if the firewalls were not there and there was this event, then you could think of worse scenarios. But I put a relatively low probability on that one. So let me – let me stop here. And then – (inaudible).

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MR. NEHRU: Thank you very much, Olivier. Let me ask you a very quick follow-up question. How would you assign probabilities between what you put as the muddling-through scenario versus the downside scenario for Europe?

MR. BLANCHARD: I will not that answer that question. (Laughter.) The – I'm an optimist. It seems to me, it's – avoiding catastrophes is well within reach. And I must say that I'm quite impressed with the progress in the very recent past. So I'm very hopeful that it will be avoided.

MR. NEHRU: Desmond, do you put yourself in the optimistic or the pessimistic category?

DESMOND LACHMAN: I don't like to look at the issues, you know, in terms of optimism and pessimism. I prefer to look at it in terms of realism or fantasy. And you know, when I look at Europe, I have great difficulty seeing how this is going to play out very well. You know, I just don't see how you muddle through. I very much buy Olivier's basic framework of looking at the idea that what you've got is you've got consumers that are over-leveraged, you've got a host of deleveraging going on, you've got fiscal adjustment, you have to have fiscal consolidation, you've got a credit crunch.

But I think that it's important to look at this in quantitative terms. And what particularly bothers me is the path that the Europeans have set themselves on. This latest fiscal compact, what they're talking about is fiscal consolidation on a major degree for countries in the periphery, not just in 2012, but in 2013 as well. So you're looking at – you

know, if you look at a country like Spain, it's trying to go from a budget deficit of 8.4 (percent) to 4.4 (percent) then to 3 (percent), you know, you're talking about 3 points of fiscal adjustment a year in a number of the countries. You know, this is true of Spain. It's true of Portugal. Italy is 2 percent a year. Greece, you know, forget about that. That is a total write-off.

But my view is that if you've got that kind of fiscal consolidation on that scale, occurring at a time that you've got economic weakness; that you've got a bad external environment, you know, you've got Germany and France slowing down a lot; and on top of that, you've got signs of a credit crunch – I just don't see how you don't get growth slowing a lot. And then we just get the repeat of what we've been seeing in Greece – growth slows, you don't meet the fiscal targets. You've got to tighten the budget again, so you slow even further. And then, you know, of course, what this is going to do is it's going to increase the size of the hole in the banks' balance sheets, that the capital inadequacy is going to occur. So you – what you're going to get is you're going to get credit tightening as well.

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So in short, I just don't see how this plays out favorably. You know, you can kick the can forward. You know, you can do this – the LTRO kind of operation a couple of times. You know, it'll mask the problems. You know, the markets will rally for a while. But I think that as you see growth numbers disappoint and as you see the budget targets being missed, you're going to see a reassessment of risk. And the reason I've got conviction of this view is because we're not talking about this occurring in one or two countries. We're occurring – we talk about this occurring in the whole of the periphery; occurring at – in Italy as well. So, you know, I think Europe is really going to be pretty much with us, that you're going to see real disappointments there.

And then, you know, the link – I would agree with Olivier, you know. You've got the links through the trade side; you've got the links through the weakening of the euro; but you've also got the links through the financial market side – you know, that what'll occur is that risk aversion comes back in; American banks get impacted. So, you know, I think that's a global event. I don't – one shouldn't lose sight about the fact that Europe, while it might be in decline, still accounts for a third of the global economy. Its banking system is huge. So, in short, I'm not an optimist.

MR. NEHRU: Well thanks, Desmond. I think we have two very contrasting views. Maybe you'll (come out ?), Uri.

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MR. DADUSH: Well thanks, Vikram. So I'm not quite as realistic as Desmond, but I don't fantasize to the same degree as the German finance ministry does, for example. The – I am very concerned, of course, about the situation in Europe. If I was to point to the single data element that worries me most, it's the fact that four of the five countries in the deepest trouble – Italy, Spain, Greece and Portugal – continue to have very large current account deficits in the middle of a very protracted recession – and in the case of Greece, and – an absolutely disastrous one. Yet they have very large current account deficits.

And that's a worry because it points to a fundamental issue of lack of competitiveness of these economies, which goes and is much less tractable – goes deeper, is less tractable – than the fiscal situation. Of course, the fiscal situation is very worrisome in and of itself. But if you're trying to deal with the fiscal problem against a background of a very seriously misaligned real exchange rate, and furthermore, against a background of such profound uncertainty about the future, including the possibility that the – that the euro might unravel, the possibility that you get what in the World Bank we used to call a big export supply response – that will – that will – as Olivier was explaining so clearly, that will be needed in order to compensate for the massive deleveraging that is occurring across the board. The probability of that in several of these countries is very low.

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Now I am less worried about Greece and Portugal, because Greece and Portugal, one way or another, can be managed. Ireland is a question mark. They're relatively small. And in the case of Greece, you know, when you've already convinced your private sector creditors to take a 70-percent haircut, that's the worst haircut anybody's ever taken, with the possible exception of Argentina. So, you know – all right.

So I'm less worried about them, in the sense that the market has already heavily discounted and they're relatively small. And at some point, the public sector's going to have to join the private sector in forgiving some of these debts. To me, the heart of the question is in Italy and Spain, in terms of the viability of the euro and the likelihood of the worst-case scenario that we have been alluding to.

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And so I don't know the answer. It's an open question in my mind whether Italy and Spain can achieve the regaining of competitiveness that is needed, and at the same time do the fiscal adjustment. If they cannot, then I don't think there's a way that the euro can be saved. I just – I just don't see it, because – whereas with Portugal and Greece you can say it's a political will issue, it's relatively small amounts of money – in the case of Italy and Spain, it isn't. In the case of Italy and Spain, it's an economic problem on the first order of magnitude.

And not even the institution represented by Olivier here has the firepower, certainly, and nor does EFSF have the firepower. And those who believe that the Germans and the Dutch and the Finns are going to allow the European Central Bank to just print money to buy these bonds – you know, I'm not saying it's impossible. I just think it's unlikely in the current political environment. So if you – if there's a variable you want to watch, it's: Are Italy and Spain reestablishing the conditions for growth – and particularly seeing a significant improvement in their external account? Because that's the only way the growth's going to come.

MR. NEHRU: Thanks, Uri. (Right here ?) I think Uri's touched upon a very key point. What is being done in these European economies? What structural reforms are being contemplated and induced that will lead to improved competitiveness, and reduce this

overhang of entitlements that is afflicting the fiscal accounts of these countries, that is going to make them – these current account deficits to contract? This is absolutely the core, I think, of the long-term issue in Europe.

MR. BLANCHARD: I think you're right. There may have been too much focus from especially the European Union on the fiscal aspect. And again, there are dramatic differences between these countries, and one has to be careful to put Greece on one side and the others on the other. But it is true that these countries face, to some degree, a fiscal and a competitiveness problem. And it's important to remember actually – that makes me think of the fiscal pact – that some of the countries which are in trouble now had a perfectly responsible fiscal policy. This is, for example, the case of Spain. So the fiscal pact would probably not have made much difference to the way Spain behaved, but Spain still lost competitiveness. And that's indeed a big issue.

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So I think there is no question – I mean, if you take – just let's go to the case of Greece, which is, you know, by far the most extreme. What does Greece need to – you know, to get back to health at some point in the future? And I won't give a date. It needs a dramatic decrease in its debt, and that's – you know, it's a – it's a subject of negotiations. And as Uri said, you know, with respect to private creditors, at this stage it looks like the haircut will be very large.

But that's only half of what it needs. And maybe in a way it's the easier half. The other half is competitiveness. It has, as Uri said, an enormous current account deficit. And there is no secret here: Either you basically increase productivity both a lot and quickly, and you keep wages – wage growth moderate; or you decrease wages. And that's an identity, and there is basically no way around that.

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What should they do? Well, they should really do both, but I think we have to be realistic about the fact that structural reforms – which have potential in Greece; I mean, one sees all kinds of places where productivity could be increased – take a while to take hold. And therefore a country like Greece probably has to do something on the wage side as well. And without these two – namely the decrease in debt and the decrease in labor costs – it's very difficult to see how they get back to health.

In addition, I think under the most – I won't say optimistic, but realistic scenarios, this is going to take a very long time. And what this implies is that, for a long time, Greece will not be able to go back to markets. And therefore the third leg of the Greek program is funding by the official creditors for as long as it takes, which might be quite long. And so in that context – and what we see is that the only way for Greece to get out of the hole eventually – we are getting into details – is reduction in debt, progress on wages, on labor costs, and a commitment by the Europeans to extend funds for as long as it – as it's needed.

I think under these three conditions, it's still a terribly ugly and unpleasant path. But it is at least one which can be tried. And that's – you know, I'm not going to get into what

the negotiations are, anything like this – but you can see, this is the way we think about things. And that’s what we want to try to help them come to.

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The problem is very – you know, in other countries as well. It’s nowhere as bad as in Greece. I think that one has to distinguish – and the problem of Italy is not – is not an external problem; the current account is actually quite – deficit is quite small. Italy is in a different situation from Greece, in the sense that Italy is not doing great. It has a high debt-to-GDP ratio, and it has a very low growth rate. But it has more or less been like this for a long time. Now the crisis made things a bit worse, so they have to do something on fiscal. But what they have to do on fiscal is not at all in the same ballpark as what some of the other countries can do. So I’m fairly optimistic that they’ll be able to do the adjustment.

But I want to go back to the point that Desmond made, because it’s something that I very strongly believe – is that fiscal consolidation is needed. There is no question. You can’t just let the debt-to-GDP ratios continue to increase forever. But you can definitely choose the speed. And we think that there’s – you know, I’ve used the expression that fiscal adjustment is a marathon rather than a sprint. I used – I borrowed – I didn’t create the expression; I took it from Angela Merkel.

But I think it’s exactly right, which is: What you need, what these countries need, is a – is a coherent plan over many years – a credible, coherent plan over many years. And frontloading it is a very dangerous strategy. Now some countries don’t have – who feel they don’t have much margin to play with because of the markets, but they might – some countries probably have, and should use it.

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MR. NEHRU: Desmond, you know, in your answer you talked about this vicious circle between fiscal consolidation, growth, credit contraction. And you were being realistic. But what advice would you offer that is different to what is being offered to the European governments today by the IMF and other advisers?

MR. LACHMAN: Well, I think that’s a difficult question to answer, because I don’t think that there’s uniform advice that you can give. It depends who you’re advising. If you’re advising the Greeks or the Portuguese or the Irish, I would be advising them to get out of the euro, to write down the debt, to take advantage of the fact that the debt is subject to domestic law – it makes it easy to write it down without consequences of being tied up in courts – international courts and being shut out of markets for a long time – because I just don’t believe that this approach of massive fiscal adjustment over several years is going to lead anywhere. It’s going to drive them into the ground.

I’d like to make an important point on structural form, you know, because this is being bandied about as if this is, you know, some sort of alternative – some sort of solution to the problem. I agree that structural form is wonderful from a long-run point of view. It puts countries on a different growth path. But in the short run, if the problem is that we’re facing inadequate demand, to cut wages drastically as is being proposed in Portugal – in

Greece right now, or to fire workers – you know, throw them out of the job – I’m not sure that I see how that creates the demand. In fact, what I see is that that is going to be another factor that deepens the recession and then compounds the problem on the fiscal side. I don’t think that there’s a way out of the box, you know, that – if you can’t get out of this box without writing down the debt and, my view is, without getting out of the euro.

Now if you’re talking about – if you’re looking from the point of view of France and Germany, I think that is absurd, what they’re doing – you know, that the least – if you wanted to give some logical coherence to this approach – what you would expect is – if you were asking the countries on the periphery to tighten their budget, to go in for consolidation – what you would think is that the countries that have got the surplus would be moving in the other direction to make room for this to occur. With all of them doing it at the same time, that is going to lead to disaster.

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So, you know, what I would be telling Mrs. Merkel is that she really needs to get away from this notion that fiscal consolidation is a great thing under all circumstances, for all countries. (Inaudible) – at the same time, that you really have to loosen up on fiscal, at least to give yourself some kind of chance – you know, because I think that, in my view – what heightens my concern right now is that the countries like Germany and France slowing a lot really just makes it very difficult for Italy or Spain to export their way out of their problem.

MR. NEHRU: You know, we could spend all day talking about Europe, but I really must move on now to the United States. And I want to turn to Uri here.

You know, as Olivier mentioned, Uri, news out of the United States is beginning to look quite good. You know, we’ve heard of this big increase in employment in the private sector. There’s news of General Motors now becoming once again the largest motor-manufacturing company in the world; in fact, today’s news is that they’re looking for a net income of \$8 billion, which is unprecedented.

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Is this part of a new trend? Or do you see this as being relatively short-lived? What are the risks out there in the United States – in the U.S. economy? And given the fact that the real estate sector continues to be so weak, will that continue to exert a drag on growth in the future?

MR. DADUSH: Yeah, thanks, Vikram. Well, as you know, I’ve had a sort of schizophrenic view of the United States for some years, in the following sense: that I think the politics is in a mess, obviously. I don’t need to tell people here that. That’s making it tremendously difficult to deal with some very profound weaknesses of the United States, of which the fiscal situation is just one. But on the other hand, I continue to have a very sanguine view of the private sector, the corporate sector in the U.S. – which of course represents – what is it, 80 percent of employment in the country.

[00:42:28]

And so, coming to the conjuncture, I think that the U.S. private sector is healing, as Olivier I think implied or indicated. And so American firms are profitable – are about as profitable as they’ve ever been. Just recently you’ve had some moderation in that profit growth. They have exhibited extraordinary productivity increases during the recession. The other side of that very rapid restructuring that has been occurring, including in the banking sector, is the – is the high rate of unemployment. You know, the rise in unemployment in this country has been very marked.

Some of what is considered a weakness in the U.S. – like the fact that the housing sector remains so depressed – I actually have a mixed view about that, because the housing sector clearly became hugely overextended. There was too much building. And there are estimates out there of a million to 3 million or more excess houses in this country. And by the way, the overextension had a lot to do with the financial bubble and the imperfections in the financial markets on the one hand, and extraordinary government subsidies given to the housing sector, which continue today – which take all sorts of forms. So the housing sector is the most volatile, accident-prone part of the U.S. economy. And we don’t need any more houses in the U.S. I’m simplifying to make the point.

[00:44:39]

So I see the current growth in the U.S. as being lower, because of the fact that the housing sector has not recovered – but also being healthier and more sustainable. And so I think that there are two big risks to the U.S. If they don’t materialize, we’re going to continue to see the gradual healing process, driven by a very responsive and flexible private sector.

And the two risks are, of course, the European situation, which, I think, is fundamentally imponderable; if you go to an extreme scenario, it’s very, very difficult to tell what this means for the U.S. economy. U.S. has international credits of \$20 trillion; in other words, countries owe it \$20 trillion. So, you know, it’s a – it’s a brave man who can say what happens if there’s a meltdown of the banking system in the – in Europe – how that affects the United States. So that’s one source of risk.

And then – but the bigger source of risk for the United States is its incapacity to arrive at a political consensus about what to do. We have never seen inequality, not quite, as extreme as it is today in the United States. We’ve never seen the stagnation of the 90 percent of incomes in the economy; the bottom 90 percent are not advancing, haven’t advanced for about 10, 15 years now. We’ve never seen that. And we’ve never seen the divisions in the Congress that we see at the moment with respect to what to do about the fiscal situation, what to do about health care, what to do about defense spending and so on and so forth. And I’m afraid that come 2012, 2013, we may end up in even more of a – of a stalemate at the moment than we have at the moment because the Senate could easily change hands. And so that’s the big risk for the United States. It’s the political risk. And we could be in very, very big trouble unless Washington gets its act together.

[00:47:07]

MR. NEHRU: Olivier, I'm going to ask you a two-part question. First of all, do you agree with Uri's assessment, and especially about the two risks? Do you have any other thought in your mind?

But the more sort of interesting question, in my view, is this latest announcement by Bernanke about continued ultraloose monetary policy all the way to 2014. But you're having a lot of expansionary monetary policies in Europe. You've got a pretty expansionary monetary policy in Japan, and many of the emerging markets are introducing now – are changing their monetary policy to once again either become neutral or expansionary. So there's going to be a lot of liquidity in the global economy in the coming year or more.

Isn't this going to lead to substantial global inflation? Isn't this going to lead to a lot of increased volatility? What is your assessment of the outlook as far as prices and inflation is concerned? And what are the implication(s)? How do countries respond to this new challenge?

MR. BLANCHARD: Easy questions. (Laughter.)

On the U.S. and whether I agree with Uri: Largely, it seems to me, I would say, there is one break and one risk. The break I've talked about, which is that, you know, previously growth was fueled by U.S. consumers and they now have become more reasonable, and something else has to come, if you want to go back to the same level of output, the same level of demand. And if you go through the list, you know, what can it be? It's not obvious. Housing is probably not going to do it anytime soon. Government spending is probably not the way we want to do it on the – on the – on the long-term basis. We don't want consumers to return to their old ways because that could create problems for later. And so it has to be net exports and that old issue of how we reduce the current account deficit of the U.S., which has been reduced because of a – largely because of low growth rates. How do we reduce it on a permanent basis? And that clearly takes two to tango, and the issue is still there. But as long as this is not solved, I think that the U.S. has a – has a hard time operating it at the level at which it should try to operate.

[00:49:16]

On the risk – I mean, fiscal is the obvious one, but maybe with a twist, which is, there is a lot of uncertainty about next year. You know, we don't know – I mean, maybe we can guess, but we don't know whether tax cuts will be expanded or not, and it makes a whole lot of difference to the fiscal impulse. And if it goes the wrong way, that could really decrease growth quite a bit. I suspect it will not, but there's uncertainty on that.

Then there's the longer uncertainty, which is the worry that the U.S. just will never get its fiscal policy in order and we're going to see that increasing forever, and maybe – God knows – default. I think that worry is probably not justified. My sense is, if I look at the way to solve the – to achieve fiscal sustainability for the U.S., it seems that a mix of taxes and spending cuts and tax increases can do it. It is not – it is a political problem more than a fundamental problem. And at some stage, one has to assume that they'll see the light.

[00:50:28]

People also worry about the fact that, you know, the U.S. t-bonds might be perceived as risky and their rate would – the spread would increase. I think, for better or for worse – although this is not impossible, I think the fact that they have the status that they have means it's not going to happen anytime soon.

My main worry in the short run is what happens to fiscal policy next year.

On the other issues –

MR. NEHRU: Global inflation.

MR. BLANCHARD: So on the other issues – (inaudible): First, on the narrow change that the Fed did, which is to indicate that we keep interest rates flat probably until 2014, that's the right message. Whether it should be framed as a message in terms of time or in terms of the state of the economy, I think, is something that can be discussed. I might have preferred the Fed to say that they will do it as long as the economy had not fully recovered or something like this, which, in their mind, at this stage, is 2014 or more.

There is the risk here that if this optimistic scenario we are talking about, the U.S. just does better, then they have to actually increase the rates before 2014. It would not be the end of the world, but it will have been better to say, we'll do it when we need to.

On whether monetary policy is leading the foundations for inflation, you know that large M leads to large P eventually. I think large M leads to large P eventually if large M remains large. And I have the sense that much of what they have done can be undone as the economy picks up, and I'm not terribly worried. I would worry if they had on their balance sheet all kinds of assets that they cannot sell, but that's for the most part not the case. So I think they can undo; they can reduce their balance sheet; they can increase the interest rate. So I don't worry about inflation for that reason.

[00:52:35]

But a footnote, which is: I think one of the main issues which is going to face advanced countries for the next 20 years is the decrease in the debt-to-GDP ratio. And traditionally it has been done through a primary surplus, strong growth and relatively low real interest rates. We're probably not going to have the strong growth. And I think there might be pressure to try to have negative real interest rates – namely, inflation running above the nominal interest rate.

We're not there. I don't worry about it now. But I think that the temptation for – in some countries, not particularly the U.S., but in some countries, to achieve reduction in debt that way will be there and will be there for many years.

So I don't think inflation will come from the monetary policy, but it might come through other reasons later.

MR. NEHRU: I'm going to ask you just one more round of questions before I open it up to the audience for questions. But I do want you to keep your answers short because we want to make sure there's enough time for the audience.

[00:53:43]

Desmond, one of the stylized facts that's emerged about macroeconomic and financial crises is if you have low interest rates or near-zero interest rates for a very long time, you end up with a crisis because money then tends to be – tends to go into very risky projects. Are we laying the foundations for the next global economic crisis right now with all this cheap money sloshing around the world?

MR. LACHMAN: I'm not sure that you've got an alternative – you know, that – you simply don't have other policy instruments, you know. And I think that you've really got to get out of the current crisis, you know. So I don't see that you've got an alternative but to try to flood the market with liquidity. You expand the balance sheets and hope that that gives you some contraction.

I guess my problem is that a lot of these banking systems are broken, so even though you are expanding the balance sheet of the central bank, that is not being translated into credit expansion of any size, or else of money size. So, you know, I don't see a risk from the price inflation side.

But clearly there is a risk, you know, there's – the LTRO is, in my view, creating a bubble in terms of Italian and Spanish bond spreads that is going to meet reality later on in the year – you know, when you see those countries slowing and not meeting their budget targets. So I'm not sure that, you know, the policymakers have really run out of instruments: interest rates (on ?) CRO; you've got problems on your fiscal side; you've got big gaps in these markets – in these economies; they look like they're slowing. What else is there, other than, you know, to try expanding the central bank's balance sheet?

MR. NEHRU: Uri, we – I want to quickly segue into China. I want to ask you your impressions – you know, one hears two stories about China. China is heading for a hard landing; on the other hand, China is coming in for a soft landing. And these two theories continue to be out there. Where do you come down on these two points?

[00:55:54]

MR. DADUSH: I continue to come down on the side of a soft landing. And I'm very aware of the concerns about housing prices in China and local government finances, following the very large stimulus package and overextension of credit, quite a bit of which is due to the local governments. But in the end, you know, not being a deep expert on China, I would appeal to the following fundamentals. Number one, this is an economy which continues to have extraordinarily strong growth drivers, starting from a low level, a lot of structural change happening within the economy, urbanization, industrialization – from still a very low relative level of per capita income, with a lot of the foundations for growth there.

So, you know, growth – when you have the underlying drivers of growth pushing in your direction, a lot of things become easier, and some risks become easier to take. So my former boss, Justin Lin, likes to say that, yeah, we have tended to have – overinvest in infrastructure, and that’s true for about two years – or three years, when you’re growing – 8 (percent) or 9 percent a year; it’s simple arithmetic. And the – and by the way, exactly the opposite is the case when you have no growth drivers. Then everything becomes more complicated, and everything becomes more risky.

[00:58:02]

So that’s my first appeal. The second appeal is to the extraordinary strength of the public-sector balance sheet, which – you know, debt is relatively modest, gross debt. And then if you take into account that \$3.2 trillion of foreign exchange reserves, which is about 60 percent of GDP, you know, that’s a – that’s a pretty solid situation from which to deal – (inaudible). And of course you are talking about an economy where the banking sector – which is where the concerns about credit are – is nationalized. So it is supported already directly – as opposed to indirectly, which is the case of the advanced countries, which however cannot afford it – by the balance sheet of the government.

So, you know – so yes, you really have to distinguish between cyclical downturns and structural change. And I have no doubt that China can see somewhat slower growth for some years, particularly in the presence of a European crisis that propagates. But I think the underlying drivers are very strong, so that they should be able to mitigate its effects much better than just about any other country.

And finally, Vikram, I want to draw a distinction between China and many other emerging markets which people do not sufficiently recognize. Many other emerging markets – like Russia, for example, or Brazil – do very well according to a lot of parameters, in a context where commodity prices are very high, and they are commodity exporters. China is a commodity importer, net, and is a big manufacturers and other exporters, so that during a downturn, (watch out ?) – a protracted downturn, not a Lehman-type downturn – a protracted downturn of the global economy, which we could have – (watch out ?), in those emerging markets, which are heavily dependent on commodity exports, be more confident about countries like China, which will actually see a favorable terms of trade shock in the event of a crisis.

MR. NEHRU: Thank you, Uri. I think I’ll forego the question to you, Olivier, and we’ll open it up to the audience, just to make sure we have enough time.

[01:01:03]

MR. BLANCHARD: Can I – can I just say one word about your questions to both Desmond and Uri? On low interest rates, I think Desmond gave the right answer. There is no choice; we need low rates. But I think what we’ve learned is that we can use macroprudential tools. Now it’s still very early on, and we still don’t quite know how to use them right. But in principle, we can get – when we see risk somewhere, we can actually use another tool than the interest rate – you know, in the case of housing (loan ?) – devaluations,

things like this. So I think the right answer is, get the interest rate where it's needed for macro purposes, and if you see risk emerging, then go at it with specific instruments.

On China, I just want to endorse what Uri said. And we basically see a soft landing. We have a forecast of about 8.2 percent for next year. It has been higher in the past, but it's still fine.

MR. NEHRU: Yeah, incidentally, on China, the international financial institutions have consistently underforecasted China's growth rate for the last 10 years or more. So it's going to be interesting to see what happens.

[01:02:09]

MR. BLANCHARD: It's very hard to do forecast with two digits – (inaudible).

MR. NEHRU: (Chuckles.) OK. Let's open it up to questions. But may I ask you to please give your name, give the institution with which you are affiliated, and keep the questions short. We'll have three questions to begin with, and then we'll do it in batches of three.

Yes, sir, in the big – in the front. Yeah.

Q: Judd Heriot (sp), documentary filmmaker. Could I ask Olivier to expound a little bit on how the three – we have the three institutions in the European bond market: We have the ESF; we have the funds facility, which it has been funding; and we have the activities of the European Central Bank in the – on the official bond markets. How are these three institutions going to coordinate their efforts in stabilizing bond prices?

[01:03:02]

MR. NEHRU: Thank you.

Q: Hi, my name is James Bond, and today I'm here with Lazar (ph). And I am – and I'm, you know, sort of –

MR. NEHRU: (Chuckles) – he really is James Bond. (Laughter.)

MR. : (Inaudible.)

Q: I wonder – I wonder whether Olivier hasn't sort of underestimated the capacity of the European politicians to grasp defeat from the jaws of victory – (laughter) – because, you know, I think Greece is a foregone conclusion. Let's face it, Olivier; I know you're at the fund, and you can't make predictions about when the fund's out in Athens negotiating. But it seems to me Greece is a foregone conclusion. It's not going to be that big a deal for Europe – a big deal for Greece. Why? Because for this – the adjustment to work, you have to get the Greeks to put up with it for 10 years, the adjustment; and you have to get the Germans and the French to finance it.

[01:03:51]

I actually want to turn to China, which I think is a lot more interesting and risky. And the question for you, Vikram, and also for the others: With a change of leadership in China today, what you're going to have is – you have to have a massive reallocation of essentially the production effort from exports to internal production, because the global markets have declined, there's much less – what is the capacity that China has to reallocate its production from exports to local consumption? And what are the risks posed by this change of leadership in the – (inaudible) – bureau?

MR. NEHRU: Thank you. Yes, please.

Q: I am Emtias Perty (ph) and a student of Ph.D. in public policy at The George Washington University. I have a quick couple of questions. First, let's get into a hypothetical situation if euro collapses. How would it affect the world economy, and especially the United States economy? And my second question is: These days, a couple of new schools of economic thought have emerged in blogosphere. One of them is especially called market monetarists. They look at that the Federal Reserve switched to nominal GDP, and in fact Federal Reserve had a meeting in November or December, and – but they couldn't sweep all the hurdles and the meeting was inconclusive. So if the Federal Reserve or any central bank in the world switches to nominal GDP, how is going – and that going to affect the economy?

MR. NEHRU: Thank you.

Olivier, can you take the Europe and the U.S. ones? And I'll also ask you to do that, Desmond. And then I'm going to turn to you, Uri, for the China question, if you may.

Yes, Olivier.

MR. BLANCHARD: Yes. I don't know exactly how to answer your questions. And these institutions have slightly different mandates, and we can go into the details.

[01:05:40]

I mean, the ECB is a – is a monetary institution. The others are fiscal. And now the question is, which one should be used to be create this fire wall that everybody's talking about? And I think you can think of extreme solutions in which – you know, if you think, for example, that the problem is that the investors – (foreign ?) investors, say, don't want to buy Italian bonds for some reason, and that somebody else should basically buy these bonds to keep the spread relatively low, you can think of (values buys ?). So some people have suggested the ECB could do it, either through this program called the SMP. But if the ECB thinks that it's not its mandate to do so, it can do it indirectly by providing money to banks through the LTRO and then hope that the banks actually buy the bonds, which seems to be what's happening, but it's not quite as direct.

Or you can think instead of the EFSF or the ESM, when it is in place, could actually do the same thing and in some form buy these bonds.

There are pros and cons into – in who should do it. From a liquidity point of view, a central bank is better equipped to provide liquidity, because it can do it more easily. It has no limit on what it can do. When it becomes a solvency issue in the sense that you're not sure that what you lent you will actually get back, then it's not entirely clear that the central bank should be in, or if it's in, it should probably be the case that its losses are absorbed by somebody else. The EFSF and ESM have structures such that in principle they could absorb losses.

[01:07:12]

I think in practice one has to be pragmatic. One has to basically build the fire walls (of decent size ?), and one has to accept the fact it's going to be a combination of some ECB interventions, maybe not exactly through the way some had hoped – EFSF, ESM and IMF funds, if needed. So at this stage we're just trying to put it all together.

There are neater solutions on paper, but the reality of it is, you just take the money where the money is and just add it up and hope it's enough.

On the –

MR. NEHRU: The implications of a collapse of the euro or the eurozone on the world situation.

MR. BLANCHARD: Yeah. I'll pass that one and – (laughter) – I mean, we have to talk about serious issues here. (Laughter.) The – but I'll take – I'll take your second question, which is much easier to answer –

Q: (Thank you, sir ?).

MR. BLANCHARD: – on nominal GDP. I think it's – you know, when you sit down, you say the central bank should care about inflation and should care about activity.

[01:08:20]

Now if people understand – understood exactly what the central bank does, there would be no reason to go further than that. Nominal GDP has a great advantage, which it basically, because it's a product of the two, indicates that you care about both. It also allows you to – (it should ?) do it in terms of level targeting, rather than nominal GDP rate of change targeting – it allows you, if there has been deflation, to allow for more inflation for some time to get back to the level target. So it has a number of advantages, and from a communication point of view, I think it has pluses. And the Fed has considered it, may consider it again.

MR. NEHRU: Desmond, perhaps you might be brave enough to take the implications of the EU collapse scenario.

MR. LACHMAN: I won't say when the EU collapses, but –

MR. NEHRU (?): The euro, euro.

MR. LACHMAN: – when the euro collapses –

MR. NEHRU (?): Euro, yeah.

MR. LACHMAN: – no, if the euro were to collapse, that would be a huge shock not just for Europe but for the whole global economy. What you'd be talking about is Europe going into a very deep recession. You'd be talking about the euro plummeting against the dollar, you know, which would be another way in which the United States economy would be hit. But I think that the most important way would be through the financial market channel, because what you're talking about is, you look at Ireland, Greece and Portugal, you're talking about a trillion dollars of sovereign debt. You know, if you throw in Spain, it's another trillion. If you throw in Italy, it's another 2 trillion. So it would be a huge shock to the European banking system.

[01:10:01]

And the United States is interconnected with that. So in the same way as Lehman had an effect on the rest of the world, you'd have that reversed. And that's the reason why the Europeans aren't going to take this lightly. And they're going to put up a fight to try to hold something that I think is – can't be held up.

I just want to say one word on the firewall, you know, that I don't think one should attach too much hope to, you know, if you got a big enough firewall, the problem is going to go away. I just reflect on the fact that the IMF and the Europeans' loan to Greece made commitments to Greece something like 110 billion euros, (around ?) about 30 percent of Greece's GDP. It didn't do too much. You know, if you've got the wrong policies that it's supporting, in the end, it's not going to hold together.

So I don't see this as a(n) issue of liquidity, an issue of financing a small question of solvency. You know, it might buy you some time, but it's not going to solve the problems. As long as they stick, you know, with the notion that these countries all they have to go through a shared fiscal policy adjustment in the – a fixed exchange rate system where you've got a credit crunch going on, I don't think the end result can be a happy one.

[01:11:15]

MR. BLANCHARD: Can I just –

MR. NEHRU: OK. Quick response.

MR. BLANCHARD: -- endorse what Desmond said? I mean, the firewall by itself is not a solution. The firewall is a second step. Once you've made – once you've established that –

these fiscal sustainability (with a ?) high probability – it's never – it's never one. But they (likely face ?) fiscal sustainability, then it makes sense to do a firewall. Going the other way, it would be dangerous.

MR. LACHMAN: Right.

MR. NEHRU: Uri, on the China question. Or you are welcome to also answer any of these other two points that were raised on –

[01:11:45]

MR. DADUSH: Yeah. Well, I – just to say that I agree with Desmond that, you know, a collapse of the euro would be a catastrophe for the world and for the United States in particular, and not just for – of course, for the Europeans. I want to elaborate there. The – on China, I never understand why Americans or Europeans for that matter recognize that it is difficult for Americans to affect the savings rates of their consumers. Imagine if you went to Geithner tomorrow and said: You know, you really should increase the savings rates of American consumers by 5 percentage points. He would look at you and say: Well, thank you very much. And – but somehow the Chinese can do this quickly. Not so easy.

However, a couple of points. One is some – sometimes we are fighting the – we are fighting the last war with China, in my view, by focusing on the global imbalances, et cetera, because China's current account deficit has come down – surplus has come down big time in the last three to four years from 7, 8 percent, if I remember, at the peak, to around 3 ½ percent now. And that is by – as a result of, you know, by definition, increasing imports, reflecting accelerating domestic demand and a fast-growing but slower-growing exports. And so the big current account surpluses today are not in China. The big current account surpluses today are in Germany – 6 percent roughly of GDP, Sweden, Switzerland, the Netherlands. Switzerland has a serious current account surplus – 13, 14 percent of GDP.

[01:14:07]

A lot of countries have significant current account surpluses much larger than in China. And China can probably not, just like the United States, operate directly on the savings rates of its consumers, but it can operate indirectly. It has a lot of needs. People forget that China's per capita income, purchasing power parity adjusted, is about one-tenth that of the United States today. The idea that the Chinese don't need more is ridiculous. They have a lot of scope for government investment, for increasing government spending. Their wages are rising very, very rapidly in real terms, in part because of competitive pressures. That is reflected in acceleration of consumption.

And there are a number of steps which, you know, the China aficionados know about, which the government could take to accelerate the process, so from somewhat faster currency appreciation to insisting on dividends being paid by the state-owned corporations and redistributing these in terms of social spending, for example, and liberalizing the financial sector, particularly interest rates paid to small depositors. These are some of the steps that the government can take. They have an arsenal of policies that they could pursue.

[01:15:42]

MR. NEHRU: Yeah, I agree. I just want to add that if you – all you need to do is to look at the 12th five-year plan, and you will see that they've already got the ingredients of a rebalancing strategy very much in place. So that's a good place to look at.

Let's go to the back of the hall, because I know there are lots of folks at the back who want to ask, and I don't want to miss them out.

All right, the person right in the back. There you are. Yes, please.

Q: Hi, my name is Daniel Molitor (sp). I'm an intern with the Center for American Progress. It seemed like you guys had touched on this. One of the issues facing the periphery at least is competitiveness, specifically labor wages relative to the core. I was wondering if you thought – if we get more data indicating the situation is continuing to deteriorate, do you think the ECB hopefully, I don't know, might address this by maybe adopting a higher inflation target or something along those lines or any form of easing?

MR. NEHRU: Thank you.

Another person in the back. I saw a couple of other hands go up there. Yes, please, the lady in the right. There you are. Thank you.

[01:16:49]

Q: Yes, hi. My name is Natalia (sp), and I'm a recent graduate of the School of Advanced International Studies. My question is this: In a country like Italy, do you think that a demonstrated commitment to fiscal consolidation could convince capital markets that in fact the outlook for the country is positive? And would that be enough to perhaps counteract the effects of fiscal consolidation and budget cuts through an expansion of capital?

MR. : I didn't hear.

MR. NEHRU: Could you repeat the last part of your question?

MR. : Yeah, I didn't understand.

Q: Oh, excuse me. In effect, it's a question about what you mentioned earlier about the possibility of maybe fiscal consolidation being maybe a positive and asking, could it be enough to convince credit markets that the outlook for the country is good and therefore expand credit?

MR. NEHRU: Which country?

Q: In a country like Italy.

MR. : Italy.

MR. NEHRU: Oh, Italy.

Yes, there was one more in the – yes, please, right here.

[01:17:43]

Q: Thank you. I'm Jin Ingwin (ph) with Voice of Vietnamese Americans. Would you talk about the emerging market, India, the Southeast Asian and the TPP with the – in respect to jobs, and if the Europeans, the EU, can also benefit from reaching out to the emerging market? And a question about the liquidity with the surplus in China: Would China play a role separately from the WTO and the IMF, and would that create any concerns?

MR. : I didn't get the question.

MR. : You mean for the IMF? Yeah.

MR. NEHRU: Let's start with you again, Olivier, on the competitiveness point and whether the ECB is a way by which that can be achieved, is a channel through – that can – that can be achieved.

MR. BLANCHARD: I mean, I do not think the ECB is open to that solution. I think they are committed to their 2 percent inflation target, and they are not going to want to increase it to facilitate wage adjustment. They think that wage adjustment should be done with open eyes, and it can be done no matter what the inflation rate is; if it requires a decrease in nominal wages, that that should happen. So I think as a forecast, no, I don't think the ECB will do anything to help.

[01:19:10]

But the point about competitiveness is fair. There is absolutely no question. I have a sense that it is sufficiently bad in a number of countries that it can only be solved by some kind of social pact in which there is an agreement on nominal wage cuts, really understanding that these should be reflected eventually in the price of nontradables and therefore lead to a much smaller decrease in real wages. But I don't think the ECB will be – will be very helpful on that front.

Should I take the question on Italy?

MR. NEHRU: Yes, please go ahead, and I'll come to Desmond as well on – (inaudible).

MR. BLANCHARD: So I think the question that many countries face is that, yes, they agree that it would better to consolidate more slowly, not so because they just want to delay, but because they realize that it is – it is going to kill growth; it's going to decrease growth. And the question is, well, they're under market pressure; so what do they do?

[01:20:09]

Now, we found – at least the – Carlo Cottarelli (ph), the Fiscal Affairs Department at the IMF, found a fascinating set of results, which is that he tried to explain the evolution of the spreads on sovereign bonds as a function of (all these variables?): the deficit, growth and so on. And what you find is markets like it very much when the deficit is reduced, and this decreases the spread. But they dislike it very much when the growth rate is reduced, and that increases the spread. It – if you put the two together by using some multiplier, which basically tells you by how much growth will be decreased when you actually do a fiscal contraction, then the net effect is actually positive, which is that the spread increases when you do a fiscal deficit because what you gain from improving on the fiscal side, you lose from the growth side. Now that's in the short run. Eventually growth picks up, but in the short run, you have these effects.

So the question is, what do you do when you're a country faced with those conditions? I mean, it's a bit like the question you asked Desmond. What do you do in that case? It's nearly impossible.

I think what you do is two things: First, you educate the market. And I realize the limits of what I said – (laughter) – but I think something can be done. And you show – and you show – you show them growth implications. You improve the credibility of your medium-term fiscal adjustment, and there's a number of rules that you can put in place, which would increase the credibility of your adjustment.

And then I think for (all?) those countries, there is – in the mind of the markets, but also, I think, in economic terms – a tradeoff. And if you can do more structural reforms and you show that you're tough on that, then you can actually be a bit more relaxed on the – on the fiscal side. So, for example, if you take, say, taxi drivers which are known to be very hard to convince and you actually win that fight, you actually gain more credibility than by contracting the budget by 1 percent. Now, you know, liberalizing the taxi driver market is not the solution to Italy's problems, but it is – it is a very strong symbol. So I think that there's some margin of maneuver which should be used.

[01:22:25]

MR. NEHRU (?): Why don't we stop here.

Desmond?

MR. LACHMAN: Yeah, just in terms of the ECB, I think that the ECB will have a lot of room to cut interest rates, you know, if they see the growth slowing. If they see inflation coming towards the 2 percent target, you've got to expect that they're going to be cutting interest rates. You've got to also expect that they're having a second round of this LTRO, which, you know, is likely to be pretty (expansive?).

I guess, you know, on the fiscal consolidation and the markets, having worked in the markets, I wouldn't hold my breath – (laughter) – to try to reeducate them on how to look at

things, you know, that they've got a particular view. I think that they'd be very concerned if Italy were now to back off, you know, saying that it's not going to go on the path that it said it was going to go. That – they'd really lose credibility in the markets, and I think that that's basically where the contradiction is, is that the fiscal tightening they're going to do is going lead to poor growth results.

[01:23:30]

If the IMF itself is forecasting Italy's growth in 2012 is going to contract by 2.2 percent and, if you've (got ?) negative growth, then you're not going to meet the budget target; you're going to have another round. So I don't see that you can really regain confidence this way.

You can – fiscal consolidation can have very positive effects on market interest rates and be very helpful. I saw that myself. I worked in (19)'90, (19)'92 in Sweden where they had a massive fiscal consolidation, and they brought interest rates down. The only difference was that Sweden was on a floating – you know, managed to get off the peg, let its currency depreciate about 25 percent, had the mother of all export booms, and that's how they squared the circle. Unless you do that, I don't see a way out.

MR. NEHRU: Uri?

MR. DADUSH: On what?

MR. NEHRU: Well, on the emerging markets question, if you kindly take that, or you're welcome to discuss these other points as well.

MS. OTTAWAY: Yeah, the emerging markets force, whether China will provide support to the Europeans. Did I understand that right?

MR. NEHRU (?): Yeah.

MR. DADUSH: Yeah. I think China is carefully considering that possibility. I think they're very open to it. I think that – I'm not – I'm not adding anything here to what you read in the papers. I don't think that China will do this unless they are convinced that the Europeans have a good game plan. And why would you expect anybody to do otherwise?

[01:25:17]

I also believe – I've taken the view very clearly that I think the United States is making a mistake by ruling out the possibility of contributing to the International Monetary Fund expansion. This is not a gift; this is a loan, a loan that may never be (excised/exercised ?) and which historically has been paid back. If you look at the available estimates of what the euro crisis might do to the United States, it's to lower GNP in 2013 by 3 percentage points relative to the base line. Now, I take this with a pinch of salt. I think it could easily be worse than that in the event of a major global financial crisis. Well, 3 percent of GDP for the United States is \$450 billion – (inaudible) – and that's lost output, OK? And, of course, unemployment and – you know, a disaster in various respects.

So my view is, if the United States was to say, look, we will consider an expansion of IMF resources and contribute a hundred billion dollars, for example, or \$150 billion – which, again, would be a loan; it's not a gift – that this would have very, very positive effects, not just in terms of reassuring the markets, increasing the firewall, but also because the United States retains a unique position in the international order today and can exercise leadership in a way that no other country can exercise still today. Now, that might change 20 years from now, but unless the United States moves in this direction, it makes it very, very difficult for everybody else, including for the Chinese.

[01:27:30]

MR. NEHRU: Thank you very much.

Let's have another round of three questions. And after this, we might have yet another round, so we will have six questions to follow. And then I'm going to ask the three panelists to give their concluding statements of two minutes each.

Yes, please.

Q: Bill Tucker (sp). I'm an international trade consultant. And I'd like to ask the panel, any of the panel, a question. China has this one-child policy. And they are raising a generation of people that are doted on by two grandparents and the parents. And my observation is, they are raising a bunch of spoiled brats – (laughter) – that are not going to be willing to work the way the Chinese have worked to produce what they have produced in the past. And what effect is that going to have on China's ability to continue to produce the goods and the services that people want?

[01:28:30]

MR. NEHRU: Somebody from the back. Yes, right at the end there. I'll come to you, sir, in a second. Right at the end there.

Q: Hassan Jeshi (ph), Master of Finance, George Washington University. I want to ask, what role would Saudi Arabia and the other oil-producing countries play in this oil economic movement? Thank you.

MR. NEHRU: Thank you very much. That's – glad you raised that, because what was missing from this discussion has been, in fact, the oil price, which is very interesting.

Yes, please.

Q: I wanted to raise some issues about the American housing market, which, of course, is at the center of –

MR. NEHRU: Can you introduce yourself, please?

[01:29:09]

Q: Oh, yes. I'm sorry. Paul Wanaka (ph), University of Maryland. I wanted to raise a question about the American housing market, which was at the center of the – of the cycle. When you have a – have a – had a bubble, one of the problems can be that you have then an overreaction on the downside. The economists, about, what, a month or two ago, said that, according to their calculations, the United States housing prices were now under – were low compared to their equilibrium by about 10 percent.

Now that's not surprising, if you have this overhang of foreclosed mortgages. But of course, the American housing market isn't one market; it's a hundred little markets. I don't want to, I guess, raise so much a question as a puzzle. About two or three months ago, the – BusinessWeek had a(n) observation that Fannie Mae was tightening up on its credit requirements in order to improve its balance sheets, and that to me doesn't make any sense. If they tighten up – they're a big participant in the market. If they tighten up on their credit requirements, that will tend to push down prices, which will tend to make their balance sheets worse.

[01:30:30]

I guess the question is: Are we following a set of policies which will make the over-reaction stronger than it should be?

MR. NEHRU: OK, thank you very much. If none of you are comfortable about this – about the one-child policy, I can quickly respond to that, but others can respond to it.

MR. DADUSH: I was hoping – I was hoping you would, yes.

MR. NEHRU: OK. Saudi Arabia – who would like to speak on Saudi Arabia? Olivier, how about you?

MR. BLANCHARD: I'll say something. So you don't want to talk about the Chinese kids –

MR. NEHRU: You're very welcome to do that.

MR. BLANCHARD: Oh, no –

MR. NEHRU: I said if you didn't want to, I would.

MR. BLANCHARD: On China – on China, you know, the notion that they are raising spoiled brats, all I can say is that the students that I see at MIT from China don't look exactly like spoiled brats to me. (Laughter.) They still look quite good, quite focused.

But anyway, on the – one of the risks we didn't talk about is clearly the oil market risk, where one can go from “muddle through” scenarios to catastrophic scenarios. I mean, it's clear what's interesting, if you look at the price of commodities over the last year, how they've come – most of them have come down quite substantially as a result of the slowdown in

growth, except for oil. And that indicates the degree of uncertainty that there is in the market even today.

[01:31:51]

Now, then the question is, could it get worse? And clearly, it could. Now, if – my team tells me that if the embargo on Iranian oil actually stuck, then the price of oil would probably go from a hundred (dollars) to a hundred and thirty (dollars). But nobody believes that it will stick because, basically, what they will not sell to us, they'll sell to somebody else; so that, in effect, the risk is much smaller.

The really worrisome one is the Strait of Hormuz, where I think – what? – 40 percent of the world traffic in oil goes through. That clearly would be an oil crisis of the type that we saw in 1973-'75, and that's a – that's a scenario that – about which I – (inaudible) – dramatically. Let me stop here.

MR. NEHRU: The American housing market, and tightening?

MR. LACHMAN: Yeah, I would agree that that doesn't make sense. You know, basically what you've got is you've got a market that's characterized by excess inventory. You've still got foreclosure process going on, and thus we're likely to see house prices falling by at least 5 percent in 2012, you know, which is a drag. So it doesn't really make much sense to tighten policy.

Just on the one-child policy, I've got a colleague at the American Enterprise Institute who focuses on demographics, you know, and he indicates that for China this is a huge long-run problem, you know, in the sense that this is going to be one of the few countries that gets old before it gets rich; you know, in the sense that the ratio – the dependency ratio is so low. So if they're spoiled brats and they don't work on top of that, China's really got a problem coming to it.

[01:33:40]

MR. NEHRU: Thank you.

Uri.

MR. DADUSH: About what?

MR. NEHRU: You're welcome to talk about the Saudi Arabia question. You're welcome to talk about the American housing market/Fannie Mae tightening question.

MR. : Spoiled brats.

MR. NEHRU: Or spoiled brats.

MR. DADUSH: By the way, I got old before I got rich, so it's not that bad.
(Laughter.)

I don't have – I don't have much to – I don't have much to add. Saudi Arabia plays a – potentially, an important role in – you know, it's one of the countries that really has wherewithal, has money, and so they can play an important role in buttressing the – contributing to the fire wall for the IMF, and for Europe more specifically.

[01:34:34]

And but more importantly, I think Saudi Arabia could play a very, very strategic role in the Arab Spring. It isn't doing enough for, you know, reasons that are well-understood, that this is a regime that is a very particular regime and that sees itself threatened by the – by the Arab Spring, among others. But it needs to kind of move ahead and think about, you know, what Saudi Arabia needs to look like 10 years from now, 20 years from now within a democratic Middle East, how it has to evolve and at what speed it has to evolve.

MR. NEHRU: Thank you, Uri. Well, the person who asked the question about the one-child policy has left, so I don't have to say anything.

Yes, please. One here, one at the back, and one here – the last three questions. First, you, sir.

Q: Yeah, my name is Sachin (sp), and I'm a student in public – Ph.D. student in public policy in George Mason University. My question was about the two “ins” that are missing, India and Indonesia. Recently Indonesia seems to have had phenomenal growth. Today's figures came out. They have been doing really well compared to the (EU ?). And India seems to have gone down and has not really picked up for the last couple of years or so. So I would like an – opinions about that, basically.

MR. NEHRU: Thank you.

The gentleman at the back.

Q: Just answer the one-child policy for me.

MR. NEHRU: Oh, OK. I'll be happy to do that.

Yes, sir.

[01:36:15]

Q: Hello, I'm Basil Scarlis (ph). I am a consultant on European political and economic issues. I've been told by German experts that we shouldn't worry about Germans – Germany's response to continued fiscal consolidation on the periphery, and as long as the Southern Europeans follow through on structural reforms, Germany will respond with appropriate policies. The implication of that would – that they'll respond with expansionary fiscal policies – it's not clear. What are the political – I'd like to hear especially Mr. Lachman's views and anyone else's on what are the realistic political prospects for that happening.

MR. NEHRU: Why don't we start with you, then, Desmond, with that last question, and then we'll move to Uri for the India/Indonesia question.

MR. DADUSH: Oof. I thought you were going to take India and Indonesia, Vikram. You're much better-qualified.

MR. NEHRU: OK – (inaudible). Go ahead.

MR. LACHMAN: My understanding is that the public in Germany isn't too excited about continuing with bailing out countries at the periphery. So I think that what the strategy is is that if one can get countries in the periphery to sign onto this fiscal compact and if they can deliver in a number of years, then you could see the possibility of Germany moving towards a fiscal union where they would be prepared – maybe entertain the idea of eurobonds. But that is many years down the road.

[01:37:45]

And my view is that you send these countries down a path that they can't possibly deliver this because what's going to occur is when they have the fiscal contraction, not only is that going to drive the economy into the ground – that's going to make it difficult for them to meet the budget targets, but what it's also going to do is it's going to heighten the adjustment fatigue that you're seeing in places like Greece right now. So politically, I don't see how the periphery is going to deliver. But this – you know, you're promising them something in the future in order to give, you know, for instance, the ECB cover to help these countries in the near term. But I don't think that this is a viable strategy.

[01:38:30]

MR. NEHRU: Olivier?

MR. BLANCHARD: Yeah, I would add something. I think that last July the Europeans, but in particular the Germans, said that if the program countries were delivering on their promises under the programs, then the euro members would do whatever was needed to fund them until they got back to health. I think that's a genuine commitment. It's also an incomplete contract in the sense that it's always ambiguous as to whether the countries did exactly what they said they would do and so on. So there is an out.

But I think there is – there is a notion that if they do what's needed, if they go through the suffering which the Germans think the Greeks have to go through and they respect the various quantitative targets which are put along the way, then the Germans will finance. I think that's the extent of commitment. I don't think Germany is ready to, say, expand demand in Germany in order to do anything for Greece. I think that's just out of the question.

MR. NEHRU: Any reflections on India and Indonesia, Olivier, from the French perspective?

MR. BLANCHARD: I don't know enough to say anything intelligent.

MR. NEHRU: Uri, any thoughts on this or on India and Indonesia, I think?

MR. DADUSH: I'll be happy to.

MR. NEHRU: All right.

MR. DADUSH: Yeah, the – I see the essence of the European problem, as I said at the beginning, as a competitiveness issue, which needs – we need to get over somehow – very, very difficult to do. But then, in the long term, the – in the – and this needs short-term support, as Olivier has mentioned. But then, in the long term, the solution and – of the euro problem has to include some form of fiscal union, you know? Call it euro bonds, but euro bonds by themselves will not be enough because you are not going to convince people to share liabilities if they have no say over expenditures. So it really is – the long-term solution has to be a fiscal union, which implies, one way or another, some form of political union, certainly much tighter than the one we have today.

[01:40:58]

And the problem is in the short term that there is no agreement about who should carry the burden of adjustment. And the Germans certainly don't want to carry any bigger burden of adjustment than they have already carried, and that is the case with a lot of the other core countries, including France, although it likes not to be in the forefront of the discussion.

[01:41:25]

And in the long run, the prospect of a fiscal union is profoundly marred by the fact that there is no trust, there is no trust that a fiscal union is not going to become a major conveyor belt of money from the north to the south. So, you know, these are fundamental political problems, and they're very, very difficult to grapple with, especially in the current context where, you know, all the help is needed in one part of Europe. And that's what makes one very doubtful about the sustainability of the current situation.

MR. NEHRU: Thank you. So while I give these responses to those two questions on China, India and Indonesia, I want to think of the last – sort of one-minute summary of your thoughts based on today's discussion.

On China, my – I have a very different view from most people. I've done some calculation which would suggest that in fact the fertility rate of China – that is, the number of children that one woman has during her childbearing period – would be exactly where it is today even if there had not been a one-child policy. In fact, the fertility rate in China is 1.6 and its per capital income is about four and a half thousand dollars and in Thailand it's 1.6 and per capita income in Thailand is around four and a half thousand dollars. Thailand doesn't have a one-child policy.

In fact, the Chinese have been introducing experiments of removing the one-child policy in areas where there are minorities, for families that have disabilities, especially where the children are disabled and so forth. And they've found that in these experiments in fact, the number of children does not increase on average; that it's about roughly where you would expect it to be for the rest of the country, which is quite remarkable.

[01:43:23]

So one of our recommendations from the World Bank is you really don't need the one-child policy anymore because the big distortion of the one-child policy is this push for having male children, leading to a big gender imbalance and the missing women and that has all sorts of other unfortunate effects which are sort of more sociological than economic.

On India and Indonesia, you know, my view is that the big difference between the – in the performance of those countries – incidentally, only recently India's growth rate has sort of – is beginning to be affected recently simply because the momentum for reforms in India has definitely been slowing. There's been the bickering between the opposition and the government parties, just as you see in the United States, except it's worse in India than it is here, if you can imagine that. (Laughter.)

In Indonesia, growth rate has been (above ?) 6 percent and it's been pretty steady for two reasons: One, I think the government continues to introduce reforms – though I dare say recently, there has been a slowdown, and I personally would worry about the future in Indonesia. But Indonesia is a natural resource-based economy and, just as Uri said, its growth rate has been driven by relatively high commodity prices, thanks in large part to the fact that it has this huge commodity user in China right next door.

So the interesting thing about Indonesia is that while growth rates have been high, driven by natural resource exports, employment has not been that affected, especially on Java. And therefore in Indonesia, the big question is how do you have high growth rates and employment. And that's a big question which Indonesia faces, and that's a whole new discussion that we can get into.

So I hope I have answered those two question, at least my biases towards those two issues.

Let me go now into reverse order. I'm going to start with Uri, then go to Desmond, and then finally, Olivier, you have the last word.

[01:45:18]

MR. DADUSH: Yeah, just one point. In these conjunctural discussions, which of course you tend to have when you have the International Monetary Fund invited, you tend to forget what is the underlying driver of prosperity in the world. And these are the long-term economic forces, in particular, technological advance and the spread of technology. And it is reflecting on that and the unprecedented capacity of technology today to spread to the bulk of the world population – all right, the emerging markets – it is reflecting on that that you cannot be anything but optimistic, I think, when you go beyond the next year or

two, where, you know, demand – demand, demand, demand – drives everything and – including in this country – optimistic because of the changes that are happening and the spread of technology that is occurring.

[01:46:34]

The potential long-term growth rate of the world is as high as it's ever been, probably somewhere in the region of 3 ½ (percent), 4 percent at market exchange rates. And that potential is rising all the time because businesses don't stop innovating just because demand is weak. It slows them a little bit, but it doesn't slow – it doesn't kill it. And therefore, you know, I remain very optimistic that once we get over these problems, including the unfortunate experiment of the euro, that we're going to be a lot better off.

MR. NEHRU: Desmond.

MR. LACHMAN: Yeah, I'm not sure that I share Uri's optimism, because I think that, you know, really, what you're talking about is you're talking about possibly a currency arrangement coming apart in a(n) economic bloc that accounts for a third of the global's – output. So I think that really, what is at risk here is the whole system of globalization if this doesn't really pan out. And I can just say that I sincerely hope that I'm wrong. The only problem is I can't see where I'm wrong, you know, in thinking that these numbers don't add up. And unlike the former colleagues I had in the markets, I haven't changed my mind in the last hour and a half. (Laughter.)

MR. NEHRU: Thank you very much.

Olivier, the last word.

[01:48:11]

MR. BLANCHARD: Good. Well, it's nice, because I'm going to be in between Uri and Desmond. I was thinking about what I would like people to remember. So I – in the short run, it's going to be a weak recovery in any case, very weak in Europe and mediocre at best in the U.S. I think that that I'm fairly sure of. The risks – it's clearly – it clearly comes from Europe. I myself think that the risk of a major catastrophe is very small, that what needs to be done will be done, if at the last minute.

Two things I would think about, thinking forward a bit – medium-run problems – the first one is I think that decreasing the debt-to-GDP ratio is going to be a very, very long process with many bumps along the way. And then for the particular problems of the euro, which I expect to remain in place, then I think the problem of adjusting competitiveness is going to be also a very, very long and difficult issue.

But then I want to go back to a thing that Uri mentioned, and he accused the Fund of being probably too short-sighted. (Laughter.) (Inaudible) – before you said it – (laughter) – which is what's very striking in this crisis is the fact that the emerging-market countries continue to grow at a rate which is anywhere between 4 (percent) and 6 (percent), 7 percent more than the advanced countries, so that convergence is really taking place – took place

during the crisis, if anything, is probably going to take place faster because the sick countries tend to be the rich ones rather than the poor ones. And that, in a ways, is a really fundamental change. And I agree with Uri, it's a change for the better.

[01:50:00]

Thank you.

MR. NEHRU: Well, thank you very much.

Thanks to all of you for staying, and thanks to our panelists. (Applause.)

(END)