THE EURO UNDER ATTACK

FEBRUARY 17, 2010
2:00 – 4:00 P.M.
WASHINGTON, D.C.

WELCOME/MODERATOR:
Uri Dadush
Director
Carnegie Endowment International Economics Program

SPEAKERS:
Desmond Lachman
Resident Fellow
American Enterprise Institute

Angel Ubide
Director of Global Economics
Tudor Investment Corporation

Transcript by Federal News Service
Washington, D.C.

URI DADUSH: Good afternoon, everybody. Welcome to the Carnegie Endowment. We're delighted to see you here, particularly since this has been a difficult period for all of us – not just in the financial markets, but out in the streets in the snow and so on. And particularly since we decided to organize this event really at the very last moment – last Thursday or Friday, I don't remember – and we are gratified that we were nevertheless able to get a small, but high-quality audience for it.

The euro, I don't need to tell you because you have voted with your feet, is under attack. In a sense, the European construct is being questioned with the crisis in Greece and the possibility of contagion onto a number of smaller and potentially vulnerable countries in the South and in the European periphery. That is the object of the discussion.

And we have asked to join us today two extraordinarily qualified people to discuss the issues. And I know from having known them for a long time – they're my partners in crime in various Washington gatherings – I know that they take somewhat different view on the question – (chuckles) – that we are going to discuss.

To my left is Angel Ubide, who is a visiting fellow at the Peterson Institute for International Economics, an expert on central banking, European affairs, finance and macroeconomic policy. And he is also a market participant; he is the director of global economics at Tudor Investment Corporation that you know is a leading global funds management company.

And to my right is Desmond Lachman of the American Enterprise Institute, who also has a history in the market and in the IMF. Before AEI he was managing director and chief emerging-market economic strategist at Salomon Smith Barney. The younger ones among you will not have heard of Salomon Smith Barney, but it was a very important force at one point – probably still is, under another name. And he also served previously as deputy director of the International Monetary Fund policy development and review department, which is actually kind of the heart, the high church, of policymaking in the International Monetary Fund.

So without further ado, let me move on to the substance of the proceedings. And I thought the way we would best do this is for me to ask a set of questions – first, to one of the participants, and then ask the other speaker to comment on what the previous one has said, or at least, to say whether they agree or disagree with the answer to the question.

And to keep it conversational, neither Angel nor Desmond know which questions I'm going to pose. They know, roughly, what the questions are, but they don't know precisely, and who I'm going to ask. So my first question is to Angel. And it is: Why is Greece at risk of default?

ANGEL UBIDE: All right, thank you, Uri. Thank you for this invitation. And I guess that's the easy question. I guess what markets are seeing in this country is that, if you check the boxes, it basically gather a lot of what early-warning systems would say are vulnerability indicators, right? It has a high deficit, a high debt-to-GDP ratio, a high current account deficit, high foreign ownership of the debt and a history, if you want, of delivering surprises with the fiscal account.

As you know, it's been a couple of times in the last 10 years, that – when there has been a transition in government, the deficit has become higher because there is – some accounting issues have come to the surface. So I think it is legitimate that some market participants may think that the probability of default in Greece is higher

than in other countries. In fact, it's interesting because markets think that the probability of default is very, very similar to that of California. And I think that basically gives a lot of credibility to that assessment.

And, you know, there is a liquidity crunch coming for Greece, in terms of the maturity of the debt and the rollover plans; they have to roll over about 25 billion euro worth of debt in April and May, and then there is some cash needs for the financing of the budget. So there could be around 40, 50 billion euro, at maximum, that need to be raised between now and May. It's going to be – if not challenging, it's going to be, perhaps, more expensive than the Greek government thought it was going to be. But I see no reason why they shouldn't be successful in achieving this.

MR. DADUSH: Desmond, do you agree with that overall picture?

DESMOND LACHMAN: No, in a word. There are some pretty, very basic reasons, you know, that I don't think that this is just a question of the markets checking off boxes. It's a question of looking at the proportion of the imbalances in Greece's economy, and it's also the realization that these imbalances are occurring in a country that is on a fixed exchange rate or, to put it even more strongly, that doesn't have a currency of its own.

So, you know, with your permission, just to give the discussion some sort of factual basis, rather than just looking at the boxes, I suggest you look at this first chart, which indicates the size of the deficit that Greece is running. So over the course of its whole membership in the euro, it has barely met the Maastricht criteria in any single year. What we're looking at is, we're looking at a deficit, now, of the order of 12-and-three-quarters percent of GDP.

And what is even more scary is that the primary deficit is 7 percent of GDP, so that even if Greece were to reschedule its debt, or even not pay its debt, it's got a 7-percent-of-GDP deficit to deal with.

So that is the first problem that one really has to ask: How does Greece get its deficit down from 12.7 percent of GDP to the 3 percent of GDP that might be consistent with fiscal sustainability or at least with the Maastricht criteria. So we're talking about a 10-percent-of-GDP budget adjustment in a fixed exchange-rate system.

Another fact that one really has to recall with Greece is that Greece collects something like 40 percent of its GDP in tax revenues. If you try to engage in fiscal tightening of this order of magnitude, 10 points of GDP, and you've got 40 percent of GDP in tax collections, it doesn't take much in the way of Keynesian analysis to say that what we're looking at is Greece's output declining by something like 15 to 20 percent, which will have just minor implications for the Greek banking system, not to mention for the Greek public.

Of course the Greek public are already protesting in the streets before we've begun this process. So this notion that Greece can stay within a fixed exchange-rate system and adjust its budget is fanciful. So I've got no doubt that over the long run that alone would cause Greece problems.

The second problem that Greece has got is that, unlike California, which hasn't lost competitiveness, Greece has lost 30 percent competitiveness in relation to, certainly, Germany – in relation to the rest of the euro. So one has to ask oneself, how do you regain that competitiveness in order to bring your current account deficit down from around 12 or 13 percent of GDP? How do you regain 30 percent of competitiveness in a fixed exchange-rate system when the countries against whom you're competing aren't know to have a strong belief in inflation?

So I'm thinking particularly of Germany. If you think of Germany as running 1 or 2 percent inflation, if Greece has to regain 30-percent competitiveness, what that means is Greece's price level and wage level has to fall by 20

percent. But if Greece's price and wage level falls by 20 percent then Greece's debt-to-GDP ratio isn't 120 percent; it's 150 percent. And if the output is falling, the debt ratio is even higher. So this is really just not a sustainable position. Something has to give.

In my mind, the only real question is the timing of the default. And, you know, here we've got the fact that Greece knows that if they were to leave the euro or be driven out of the euro for any reason, this is a problem for the rest of the system – they know they're going to get bailed out. So I think that that is the only real question at stake. It's not a question of if Greece is going to default; it's not a question of if Greece is going to leave the euro; it's a question of how long does this process take.

MR. DADUSH: Okay. Thank you very much, Desmond. So basically Desmond's view is that this is an essentially unmanageable process in the current context. Something big has to give. If I'm paraphrasing Angel's view correctly, it's that we have major debt problems, but one way or another, they're going to be managed.

Let me now move to the second question, and ask Desmond this time to respond first: How are the European partners responding to this? How do you evaluate the response, so far, of the Europeans?

MR. LACHMAN: Well, my evaluation is that the Europeans, for the most part, understand what is at stake. They understand that if Greece leaves the euro, there would be immediate pressure on the other weak European countries – and I'm thinking here of Portugal, but more importantly, I'm thinking of Spain, which is really the big one, and that is where the game is going to be played, and of course, Ireland as well.

So they know that if Greece were to be forced out of the euro, default on its debts, you'd have contagion right through the system – and that the very notion of the euro in its present form would be at stake. So Greece has enormous leverage in the negotiation. I think I was disappointed – I shouldn't say disappointed – just as an observer, what struck me is the reluctance with which the German public is going along with the notion of a Greek bailout.

So I think that what we've got was an indication. We understand the problem, but we've got absolutely nothing in the way of specifics. How exactly is this bailout going to be done? Which informs me that there's a lot of reluctance about the process. I actually believe that they will get bailed out the first time, but I think that all the signals that we're getting, is this is a one-shot deal, that Greece won't get bailed out on a continual basis. The German public just won't accept the fact.

I should just back up and say that the European treaty itself believes in not having a bailout clause. That's not stopping the ECB from bailing them out through the back door, but this is something that really cannot go on, on an indefinite basis.

MR. DADUSH: Angel, any reactions to that?

MR. UBIDE: I'm really mystified by the commentary that Greece would choose to leave the euro because I just don't understand what it's based on. It's like saying, you know, why doesn't California leave the U.S. dollar or Florida or Michigan, for that matter? I think Michigan would benefit from a huge depreciation on the exchange rate.

But not only that. It's that the logistics would be terribly complicated. Now, imagine again if Michigan were to leave the U.S., what would happen to the banks that are based there? How do they convert the liabilities and a lot of their accounting into a different currency?

The legal issues, I think, people don't understand, but a country – now, with the Lisbon Treaty, a country can choose to leave the euro. It wasn't clear before. But it has to be agreed by the European Council; it has to be agreed by the rest of the partners in the European Union. And it's a process that could take, according to the legal documents, a couple of years. So it's not something you do, like, I think Marty Feldstein was proposing that if you just leave for a couple of weeks, the value will come back.

That's not possible. Right, because also, once you leave, then if you want to rejoin you have to go through the accession process – and, you know, the accession process also takes a couple of years. So it is a much deeper situation where there is a political commitment to a European Union and a European monetary union and that's it.

So the question is, how do you deal with it? So let's forget about the issue of leaving. And how do you deal with it is, basically, understanding that perhaps some of these countries were growing too fast. And now it's the time to adjust. And it's a political message that the authorities need to give to their people; that is, it's the time to tighten their belt.

Some countries, maybe, are privileged so they don't need to do it so often. Other countries need to live by the market discipline, but frankly, I mean – take other countries like the U.K. with a 10-percent deficit and an 80-, 90-percent debt ratio. There are other countries out there who have their own currencies, and who are also going to have to be abiding by the laws of economic and market discipline. I don't see why this is very different.

MR. DADUSH: Okay, Desmond. You wanted to come back on California, just briefly?

MR. LACHMAN: Well, I think that there are quite a few issues that Angel raises. For instance, that if he talks about the United Kingdom, basically, what the United Kingdom is going to do is something rather similar to what Sweden did in 1992, which makes the fiscal adjustment feasible. If you're needing to adjust by 10 percent of GDP and you move your currency – you allow your currency to find the level that it finds, like in Sweden's case, it allowed the currency to depreciate by 30 percent – then you've got an export offset to the 10 percent of GDP contraction that you're getting from the fiscal adjustment.

If you try to do the fiscal adjustment without the currency move, that's a sure recipe for a depression. A sane country is going to be opting to want to use the currency to incentivate (sic) the external sector of that economy, so that you've got an offset to the fiscal.

Just in terms of California, I just find it rather amusing that, you know, somebody like Trichet keeps talking about, well, we've got Greece, but you've got California. What he doesn't observe – or, you know, I'm not sure whether he's aware of the fact – California, for all of its troubles – and I don't want to minimize the troubles that California's got – California just happens to be running a budget deficit that is 2 percent of its product of around about $2 billion. Greece is running a budget deficit of 12-and-three-quarters percent. California happens to only have 8 percent of its product in terms of debt – it's got a debt of something like $160 billion. Greece, a country that is a seventh of the size, manages to have a debt of $400 billion. So we're really not comparing apples.

But the final point I'd just make on California is, being in the United States, where we've got labor market flexibility, where we've got wage flexibility, California's prices and wages are not out of line with those of the rest of the country. So California does not need to have a massive devaluation in the same way that Greece does. So I think that to bring in California is really just a red herring that deflects from the real problems that are at the heart of Europe – I mean, unless one wants to engage in schadenfreude.

MR. DADUSH: (Chuckles.) Okay, all right, thank you very much, Desmond. Let me move to the next question, which is: How bad is the situation, really, in the other countries that are listed among the vulnerable ones? I will not use the usual acronym because I find it repellent.

How do we assess the vulnerability of Portugal, Spain, Ireland and Italy? And since I'm only giving you about two to three minutes to answer that extraordinarily complex question, you can certainly just give us the headlines. Angel?

MR. UBIDE: Well, I mean, it's not easy because it's not easy for any country to come back from a fiscal adjustment like this one. But if I can use these two minutes, at least, to clarify a few things – you know, everybody talks about Spain, right, and says that Spain is the big problem. Krugman is obsessed with Spain now and Desmond mentioned it before.

Well, I think there is a lot – I don't know if it's misunderstanding or misinformation about this – but it's a very simple case that people make about Spain. Spain had a huge housing bubble and a huge loss of competitiveness therefore it's toasted. Right? Well, when you look at the numbers, there are things there that are important to see. For example, the competitiveness. Yes, if you look at, for example, a chart similar to the one that Desmond put before about real effective exchange rates, it's true, it has depreciated about 20 percent in the last 10 years.

When you look a bit deeper, you realize that manufacturing unit-level costs, in relative terms, are essentially at the same level as France, and it hasn't moved differently from the euro area. So there has been a problem of loss of competitiveness in the non-tradable sector, but not in the tradable sector. In fact, what is even more interesting, the market share of exports of Spain has increased in the last 10 years, according to OECD data, something that has not happened for countries like the U.S. that put the number 30-percent decline in their currency.

So Spain has a structural problem of potential growth for the next few years that is, basically, mostly due to the lack of reform in the labor market, and a few other issues that we can discuss later on. It's not something you solve with a 20-percent devaluation of the currency. And I think that's important. Spain has its problems; there will be a political will or not to deal with them; but it doesn't mean that it cannot continue growing at a decent level over the next 10 years. And you know, the debt-to-GDP ratio is just 60 percent. I know many G-7 countries that would love to have that debt-to-GDP ratio now.

MR. DADUSH: Thanks, Angel. Desmond, do you want to pick up on that? I mean, either on Spain or Ireland, Portugal or, God forbid, Italy, which is one of the largest economies and which has seen very little growth in recent years?

MR. LACHMAN: Yeah, I think, you know, my view is that all of those countries have got extreme vulnerabilities and are going to be very difficult to deal with in a fixed exchange-rate system. Different countries have got different problems. You know, you can take Ireland where it's got a budget deficit problem, but what it's done is guaranteed something like 170 percent of GDP of the bank debt, you know, which is a minor consideration.

The real one that, you know, I disagree strongly with Angel on is Spain, where I think that the competitiveness problem, the loss of competitiveness is a huge problem, as is the budget deficit that it's now running up. So what you see in this chart is Spain has run a huge current-account deficit that, at the peak, it was running a current-account deficit of $150 billion; now it's got a budget deficit of 11 percent of GDP.

I'd use the same kind of logic as I would with Greece, that let's start with Spain having an unemployment rate, already, that has gone up from something like nine to 20 percent with the bursting of the housing bubble. So what we've got is we've got a budget deficit that is 11 percent of GDP. So I'd use the same kind of logic: If we're now going to try to adjust a budget deficit by six, 7 percent of GDP at a time that our housing market is still busting – that, incidentally, the housing bubble makes that in the United States look like it was a picnic; you know, nothing much to worry about. You've still got that bust to occur.

So Spain is going to be deep in recession. Unemployment is going to be rising a lot if they try to adjust this budget deficit. What I'm really concerned about is the external side because, you know, if you just look at this next chart, this is telling you what's happening to Spain's external debt; that Spain is now – has managed – while Angel is right – that Spain doesn't have that great a public debt problem yet. But with 11 percent of GDP, budget deficit will get there.

Spain has really got an external debt problem of a huge proportion. This is like 135 percent of GDP. Somebody is financing Spain's public and private sector. You can't count on that going on forever. So it's once again a question that Spain is going to have to regain competitiveness within the euro. What that means is many years of deflation that is just going to feed into their fiscal problems, and so on and so on.

So I think that Spain is – at least I see Spain as being – hugely vulnerable.

MR. DADUSH: Okay, well, thank you, Desmond. Let me ask you this one. I mean, if you have such a dim view of the prospects for Greece and Spain and implicitly at least for the other economies, is this dangerous for the euro? Will the euro survive?

MR. LACHMAN: I guess let me mention two things. One is right from the start, in 1999, both Milton Friedman and Marty Feldstein correctly, in my view, pointed out that the euro did not satisfy the conditions of what economists call an optimum currency area. Put another way, the euro was a political idea, not an economic idea. It didn't have the economic foundations.

Both Marty Feldstein and Milton Friedman would have been surprised to see how out of whack these countries have become in the course of the period. So basically you don't have the right conditions. I've also seen, with my experience working on Argentina, which is conceptually the same sort of thing as this, that these exchange arrangements that are supposed to be immutable turn out not to be so.

I wish I was a bit older and I could have said that I saw the gold standard coming apart, but I didn't quite see that. But, basically, if you've got real problems in – if it were just a question of Greece, I would say that the euro would have a chance at surviving. Greece is a relatively small country: $400 billion is not that much debt

But when we begin to talk about problems in Spain, Ireland, Portugal, probably Italy, I don't see this as a long-run proposition. I would just say that the stakes are incredibly high. So what my expectation would be is that policymakers are going to keep kicking the can forward, but they're not going to be solving the underlying problem.

And my experience has been that policymakers tire of doing it – or alternatively the populations tire – of footing the bill.

MR. DADUSH: Angel, is it true that investment is pulling out of the euro area?

MR. UBIDE: (Chuckles.) No. Let me make a comment before I get into that. But when we hear Desmond talking, it seems that the whole problem here is that the euro-area countries have a fixed exchange rate. So I guess the solution for all of those countries that now have a debt-to-GDP ratio that is above 60 percent, they all just have to devalue and the problem is solved.

So is the U.S., U.K. and the rest of all the G-20 countries that have a debt-to-GDP problem going to devalue? And against what? I think we should forget about the issues of the exchange rate. We need to solve a fiscal problem. The fiscal problem is going to be solved by a fiscal adjustment everywhere and by structural reforms that lift productivity and potential growth.

And let's forget about the exchange rate. If markets decide that Europe is the ugly sister in the next 5 years, the euro will depreciate at 20, 30 or 40 percent and it will help restore the competitiveness of those countries that need it. But what I don't think we can focus is all the time on whether the fixed currency is the problem.

Now, is the euro an optimal currency area? You know, one of the issues back in the late '90s was the euro is not a good – an optimal currency area because it doesn't have labor mobility. Well, the last 10 years, there has been huge waves of immigration that have essentially make up for the lack of internal labor mobility if you want. So that's not necessarily true anymore.

There has been a huge financial market integration and that has forced a lot of integration in capital markets. It has lowered the cost of capital. So it has become endogenously something close to an optimal currency area. I don't claim it is, but I don't think it's correct to say that it's not an optimal currency area.

Now, there is one problem: The policy framework is not complete to be an optimal currency area. It should have a common fiscal policy and it doesn't. And that was a political decision. So what I think we are seeing now is that the policy framework is a bit incomplete. It needs to be completed and we need to see whether there is going to be a political decision to complete that framework for the future.

MR. : (Off mike.)

MR. DADUSH: Now, maybe hold for a minute or two, Jeremy. Just come back to it. Let me ask on how – let's assume that Desmond is wrong and all we have is several years ahead of us of structural and fiscal adjustment, very difficult, and then occasional flare-ups – right? – with crisis, et cetera. What does this mean for the rest of the world? Will this have spillovers on other countries, other emerging markets or even other countries with large debts like Japan, for example?

MR. UBIDE: Well, I think, as you say, this is basically, if you want – I'm not completely sure, by the way, whether we are talking here about a crisis of credibility of the euro project or we are talking about a sobering debt question mark because if we are talking about the former, then it's something that should be just related to the internal working of the euro area.

If we are talking about the later, then as you say, you basically have of the G-20 that is going to have problems. And if governments don't adopt a credible fiscal adjustment path, I could see a situation where basically we start passing the hot potato, looking for that country where the fiscal plans are not credible, the policy rules are not credible and the political equilibrium is basically conducive to fiscal disorder rather than order. I think this is basically sending a clear signal to many other governments around the globe that they need to get their act together.

I think emerging markets, by the way, are in very good shape because they already went through this. They took the hard adjustment post-'98. And we have seen in the last few years that they have been to implement countercyclical fiscal policies, something we never thought it was going to be possible to do. And so they may become the safe haven at some point if we start having doubts about other G-7, G-10, G-15 countries.

MR. DADUSH: Desmond? Are other countries at risk from this process?

MR. LACHMAN: My observation these last couple of years has been a event in Iceland in round about 2007, you know, country of a mere 350,000 people – fishermen no less – sent ripples right through the global financial system. Last year – towards the end of last year – we had a little incident in Dubai World that sent ripples through the financial system. How much more so if we were really to get a creditor binge in a country like Greece? You know, we're talking about $400 billion in debt.

I just got – this is I guess the last slide that I'll put up – it's just showing Greece's debt in relation to debt in Argentina and Russia, you know, at the time of their crises which sent ripples through the world. So there's absolutely no question that if Greece got into deeper trouble, the United States, the rest of the world would be impacted through the damage that $400 billion of additional losses would do in the euro zone. What I've said before is that if you were to get a creditor binge in Greece, you'd also get credit problems in Spain, Portugal, Italy's would come into question. So you're talking about huge amounts of money.

So you know, I think that what is going on in Europe is not a European event. And the channel is not that we're going to have slower growth in Europe; we're going to have the dollar continuing to appreciate. It's rather that the channel gets ricocheted through the world's financial system. That's the one thing that we should have learned the past 2 years, as we've a very interconnected global financial system and losses of these sort would be Europe's subprime lending problem.

MR. DADUSH: Thank you. Desmond, I'm going to ask you a question that is very, very difficult for you to handle. What is the best case scenario that we can expect out of this? (Laughter.)

MR. LACHMAN: Let me put this in terms that probably will be a lot easier to understand. As the great economist Woody Allen would have said that Europe has arrived at a crossroads. The one path leads to ruin and destruction. The other leads to total extinction. And I hope that the policymakers have the wisdom to make the right choice. (Laughter.)

On a more serious note – on a more serious note, that's essentially what you've got is you really do have bad options. And what I wanted to respond to Angel is I'm not saying that you go the currency route because that's going to solve all of your problems. I was around in the case of Argentina; it didn't solve all of the problems, that you had the trauma, you couldn't get past trauma, but at least what you did is you set the stage for a possible recovery.

So I would say that for me, the upside would be that we stop pretending that this isn't a solvency problem, that we address this problem, that the longer that we delay it, I think that's where the worst case scenario comes. I really do object to countries like Greece going to be saddled with a lot of official debt that they won't be able to reschedule when the trauma comes. So I'm not sure that it's in their interest – in the Greek's interest – to have this crisis delayed.

MR. DADUSH: Angel, do you want to comment on that?

MR. UBIDE: Well, I think we have plenty of examples in history of successful fiscal consolidations that have not necessarily even involved a decline in the exchange rate. Granted, as I said, you know, if a sufficiently large amount of the euro area is undergoing this, I would guess that the currency would depreciate and that would hurt the process. But even in the last 10 years in the fixed exchange rate system, there has been periods of consolidation of a structural adjustment – structural fiscal adjustment in the euro area of three or 4 percent of GDP over a period of two or 3 years. So that's not something that cannot be done.

I mean, Greece has plenty of room to adjust. For example, they have one of the lowest retirement ages out there. They can increase the retirement age and that in one shot essentially fixes a lot of the debt sustainability problem. They have plenty of room to fix the tax administration system. There are many things that they can do; it's a matter of political will to do it.

And I think we have seen in the past that this is possible. It can be done successfully. And I don't see why it cannot happen now. It's very easy to paint the worst case scenario. Just speak the scenario that you know is going to fail. What I think is difficult is to pick the one that is politically possible. And that's where I could have doubts about the way some of the things have been managed and about the political incentives here or there of some of the different actors. But I have no question that this can be done.

MR. DADUSH: Okay. My last question begins to Angel. It is said that crises hide opportunities. And given the magnitude of this crisis, there must be a gigantic opportunity – (laughter) – hiding somewhere behind the scenes. And I'm asking Angel, what is the opportunity here? Are there lessons here for Europe going forward and how it should change the management of its affairs? And I'm going to ask Angel first and then I'm going to ask Desmond? And then we will conclude and turn it to questions.

MR. UBIDE: I think there are a couple of lessons here. I remember a few years ago, there was plenty of research being done about why were spreads in the intra-euro area spreads so narrow. So essentially there was this fear that markets were not applying enough discipline to the soaring debt of the euro-area members. And I think those fears are now showing to be correct. There is something implicit in a euro area like that that basically weakens the discipline applied from the markets. And they may reveal that there is need for a stronger – let's call it – coordination of policies inside the euro area.

There is a related point that is the following. There is an asymmetry always inherent in fiscal policy because the political economy of fiscal surpluses is just very difficult. Right, a country like Spain probably should have been running up – I don't know – five, 6 percent fiscal surplus given the way the economy was operating. You had a common currency, had a common monetary policy, the only tool that had available was fiscal policy or superadvisory policy.

They did a very good job with macroprudential policy. You know they applied a statistical provision and it was very rigorous in lending standards. And that ensured that despite the house price appreciation that was probably one of the fastest in the world, the losses of the banking sector are very well contained, no matter what Desmond may comment about that.

But fiscal policy was not tight enough. Why? Because every time the government was about to run a 1 percent fiscal surplus, there were claims coming from everywhere and calls to invest in public infrastructure or to basically send the money back to the citizens. It's very difficult to run high fiscal surpluses. And that creates a problem inside a monetary union because it creates an inherent asymmetry here.

So maybe what we are learning is that there is a need for a bigger component of a common fiscal policy. And the need for a common, coordinated policy in the following sense: When a country is running a big deficit, there has to be another one probably running a big surplus. So this is not only about making sure that Spain and Greece don't run a current account deficit in the future. It's also about making sure that Germany doesn't run a huge current account surplus in the future.

And this is about an intra-European thing. Don't take it as a G-20, U.S. versus Germany or China versus Germany. I'm limiting the debate to the intra-euro area. And I think it's important. So one could argue there should be an economic summit next month and there should be a decision whereby Greece is going to adjust, Spain is going to adjust and Germany is going to expand – which by the way, it's happening. Germany is basically expanding fiscal policy this year. The question is whether one could make the case that fiscal issues make – that German should make an even bigger fiscal expansion.

MR. DADUSH: Desmond?

MR. LACHMAN: What can I say? You know, that this has really just been a disastrous experiment, you know, that it's a little bit late in the day to begin thinking how we might have done this better. You know, I think what one could perhaps say is that Europe would be making a big mistake by including more member countries joining.

Where I would agree with Angel that what would be really very helpful in this situation – you know, which would perhaps make the adjustment less harsh for the deficit countries – were if the surplus country in the area, the large surplus country Germany would engage in fiscal expansion. My understanding, though, is that the Germans are committed to a budget – a constitutional amendment that is talking about balancing the budget irrespective of what the needs are of the members. So you know, the idea that Germany is now going to engage in an expansive fiscal policy to bail out the rest of the members from this is just not on.

You know, all one has got to do is just read Otmar Issing in yesterday's Financial Times to know the way in which the Germans are hankering for the hard deutschmark of the past. And I don't think that they're going to debase their currency in order to bail out the likes of Greece and Spain.

MR. DADUSH: Okay, thank you very much. That concludes the sort of formal part of the discussion. If you're feeling completely confused, we have achieved our purpose because we really wanted to encourage questions and comments from the audience that includes some live participants from the countries most directly affected. At some point, I will turn to Antonio de Lecea, who is the economic counselor here at the EC – European Commission – or, European Union embassy – to give his reactions at some point turning the proceedings. But let me ask if there are questions. And Stefano, do you want to –

Q: Thank you, Uri. I think it was very interesting –

MR. DADUSH: Please introduce yourself. Sorry about that.

Q: I'm Stefano Beltrame from the Embassy of Italy. I'm the head of economics at the Embassy of Italy. And I found very interesting this discussion because I was looking at the past 2 years and the experience of the euro to me is different from what we learned today. I think that the experience of euro was the one of giving the great stability.

And I was watching yesterday TV. There was former Secretary of Treasury Paulson presenting a book he just wrote: "On the Brink." I don't think he was referring to the euro zone. I think that what we are talking about,

vulnerabilities – talking about vulnerabilities, what we saw in 2008 was a very interesting time in history. We will go back and check and study what happened in 2008.

But one of the things which I think should be obvious even here in the States already today is that the crisis started out of vulnerabilities which are outside the euro zone. And in fact, in that situation, the euro zone did contribute to stabilize the European countries in dire straits outside the euro zone. There was a key element, which was the October 2008 conference of the big four European countries to support another European country outside the euro, which I think did make a different in handling the crisis in 2008, which might have gotten consequences that everybody would remember.

So if you look back, I would say the experience of Europe, even though I understand it can be difficult to understand because it's complicated – it's complicated for us as Europeans – but at the end of the day, I would say that the euro gave a huge contribution in stability over the past 2 years. And just to build on that and to spread the understanding, I would say 2008 is comparable to the '29 crisis but the way it was handled was much, much, much better, we were commenting before with Tim Adams. And the international cooperation which we saw in the past 2 years was totally absent in the '20s and in the '30s. And this is why we have a different situation now.

But to my understanding – maybe this is personal – but euro at the end is the nephew of the German experience of hyperinflation of the '30s which followed the '29 crisis. And because of that, in the German constitution, the German citizens have a constitutional right to monetary stability. And I think being Germany is a big part of the euro – much bigger to the euro zone compared to Greece.

And if you make the parallel much bigger, the parallel between Greece and California should also be considered in the size of that part of the country compared to the rest of the euro zone. So the fact that the Germans have in their constitution the right to monetary stability should be a given to the stability of the euro.

At the end of the day, why you accept a piece of paper for things is currency is accepted only on a point of confidence. That's it. The only thing. In Italy, if we go back in history, there was a time when Florence was giving a lot of money to the king of France. And said, okay, we control France. Then, the king of France did not pay the debts and Florence went down. So currency has a value only as far as it's accepted, is a point of consonance. So when we talk about currencies, we also have to bear a respect for that. Thank you.

MR. DADUSH: Thank you very much Stefano. Other comments – I'd like to take comments or questions from the audience – two or three – before turning back. Any reactions? Yes, the gentleman there.

Q: I'm Stephen Glain of the Abu Dhabi national newspaper. You talked about comparative advantage and competitiveness. Is the possibly of a Chinese appreciation of the renminbi sometime this year, possibly next year, a factor at all in your projections or outlook for the future of the euro?

MR. DADUSH: Interesting question. Others? No? Okay, then let me turn back to the panel and, perhaps, Angel you want to go first?

MR. UBIDE: I think one thing that is important to stress – and I'm going to basically follow on what Stefano was saying – is that the euro system works at the end of the day. And last year, 2 years ago, there were plenty of question marks about would the euro area be able to solve a banking crisis. You remember all those talks about the euro not having an ex ante burden-sharing, not having a common supervisory system.

And I think at the end of the day when we look back in history, we'll remember that there was one country that essentially had plenty of trouble putting together a banking rescue package and that was the United States. It wasn't the euro area. The euro area was done. There were doubts. The leaders got together in a weekend; they said, we will do it; it was done. Here, I think there were a few issues going on in terms of convincing the Congress and in designing how to do it.

I think at the end of the day, what we have seen is that the political will normally solves the problem. There are political constraints and we need to take those constraints as given. But that doesn't mean the system doesn't work. It's not optimal, again, but it works.

MR. DADUSH: Desmond?

MR. LACHMAN: You know, I really think that it's far too early to be drawing definitive conclusions about this crisis, you know. This is an ongoing crisis. Whether the euro served Europe well, I can concede that 2008 might have been okay, but where we are in 2012 or 2014, let's see if this thing can hold together.

The issue on the banks, my understanding from IMF reports is that Europe is yet – it's behind the United States in recognizing loan losses and in addition to the West European countries that we've been talking about, Europe has got – West European banks has got $1.5 trillion exposure to the East European countries. You know, and I mentioned that if this crisis deepens, we're going to have problems in places like Latvia, Ukraine, Bulgaria, Romania and so on, which will really cause problems in the European banking system.

One point I'd also make is that I don't think one should take much comfort from the fact that the United States might be in trouble, too, or that the United States economy might be slowing because if we really do have the United States now stalling, that is really the one hope that Europe has got that it can actually export its way out. So if you do get the United States for any reason having a renewed crisis or going into a double-dip recession, I think that is really terrible news for Europe and it will just hasten the coming apart of the euro zone.

MR. DADUSH: Can I ask you though to comment also on the gentleman's question on the renminbi? Is that linked to these issues? Will it help if the renminbi appreciates?

MR. LACHMAN: Oh, it certainly will help if the renminbi appreciated because what that would do is it would lessen another risk. I should just mention that so far I've been given my baseline case, which is my optimistic case. My pessimistic case is what are the downside risks? And one of the downside risks is that China is running policies that just seems to be inviting a protectionist backlash in Europe and the United States, not least of which is China has got the gall to peg its currency to the United States dollar at a time that the dollar was depreciating against the rest of the world.

A country that is running – has got $2 trillion in reserves and running humongous current account surpluses to actually be appreciating its currency in real, effective terms is not very helpful. So my short answer is that if China were to make a substantial appreciation of its currency, that would be very helpful to the global situation because I fear what happens as we run up to the November 2010 elections, there's very big risk that China-bashing together with bank-bashing is going to come back into fashion.

MR. DADUSH: Angel?

MR. UBIDE: I would just advise to lower the focus on the renminbi, really. I think what matters is that China generates domestic demand. And China has generated a lot of domestic demand in the last year-and-a-half. They

put the most forceful policy package in place and they generated a lot of the growth that has contributed to pulling the rest of the global economy out from the hole. So I think there are many things related to the Chinese policy mix.

I'm not sure I agree with the idea of having a fixed exchange rate, as a matter of principle. So probably I would prefer to have a floating exchange rate. I don't have a strong view on whether that currency could appreciate or depreciate if you were to float it but that's a different story.

But I think what is important is that China puts in place the conditions for a strong domestic demand. They need to encourage, really, disposable income of the population, they need to strengthen the safety net and they need to build infrastructure for that country to operate. And a big chunk of the stimulus package they put together last year was, really, infrastructure, was the building of the main components for that country to become more productive and to continue to grow. And so I would try to diffuse a little bit the attention on the currency.

MR. DADUSH: Great wisdom in that comment, if I might comment, myself. Antonio, do you have any views on the prospects for the euro areas at this point?

ANTONIO DE LECEA: Well, first of all for giving me the opportunity to express some of our views, even if some of those that I wanted to express have already been expressed, and even much better than I would have done, by Stefano and by Angel and by others. And thank you also to Desmond for a provocative and thought-provoking presentation.

Yes, we have some views. And to start with, I would agree with Desmond on a couple of things. The first one is that what we must do is to set the stage for recovery. Maybe the instrument or the recipe is not the same that Desmond would propose but I agree that the point is setting the stage for recovery. And I would also agree with Desmond that the longer this is delayed, the more serious the problem will become. And I will come back to this in a second.

What I wouldn't agree with Desmond is in the apocalyptic type of presentation that he has given because it reminds me of the past where at every stage of the EMU construction, there were these apocalyptic types of prospects. And I must say that so far they have proved wrong. And when, I mean, after a long while, they have proved wrong, something may be wrong in the theory. And what is wrong in the theory? To cut it very short, I would say that there are two or three issues. And again, if you allow me, I will come back to that briefly.

The first is that policymakers will not be solving problems; they will keep on kicking the can. And secondly, that the markets will continue to not pay attention to the fact that those scenarios – those apocalyptic scenarios – don't prevail and they will keep on kicking until this scenario becomes true. So I don't believe that these assumptions or these premises are right. So I would try to dispel this sense of alarmistic that is being given in the media and in some debates.

And to explain this a little farther, it is clear that EMU has been since the beginning a unique construction. A unique construction that had clearly economic components and political economy components. And it is clear that if we had waited until all the conditions – the optimal currency conditions, all the policies were in place – it would have never taken place. So we started by having the core and then we adjusted. And this has happened. This has happened and one could have never thought that the Germans would agree to foregoing the Deutsche Bank. But it happened.

I remember because I was quite involved, before the switchover from national currencies to the euro notes and coins. Again, the apocalyptic scenarios were floating in the air. It went very smooth.

Then, Angel mentioned the situation in the wake of the financial crisis. Markets and many public opinion-makers didn't believe that Europe would rise up to the challenge and get together and have common positions. But they did. So, I mean, there is a process of learning by doing, but so far we have matched.

And what matters is the political will. It's true that in order to make these political decisions feasible or easier, sometimes we need to be on the brink of a crisis. But the politicians don't keep on kicking the can. They rise up to their responsibilities. And also, markets – not every time but sometimes – they understand that they need to adjust their strategies and take account of economic and political realities.

So as Angel said, the euro is – it is difficult to conceive of countries leaving the euro. It has proved a big success, and for that, let me refer you to the study that the commission produced with the contributions from many academic and other scholars in 2008 on the occasion of the 10 years of EMU. There, you will be able to see many of the pros and cons. I think it's a balanced study.

But just to remind you, besides the stability that is the paramount achievement, we also managed to increase per capita GDP in the last 10 years. This is not known – or, this is not publicized. So maybe the U.S. has had higher productivity but it has also had higher population growth, so that in terms of GDP, the pace has been more or less equal.

Europe has undertaken very important structural reforms. This is not publicized. But it has created in the last 10 years more employment than the U.S. This is [58:25] known. So politicians don't always keep on kicking the can.

Despite the dollar's role as a safe haven, the euro has developed farther than the legacy countries. So it has increased its role in the international markets. So farther more, we may agree or disagree on the pitfalls of the economic policy surveillance system, but it has worked more or less, with some exceptions – and Greece is one – but overall, it has worked with crisis. I agree.

So this is so far. So now to take, Uri, your question – what's for the future? And again, the report – the study that we produced – already identified a few problems. A few problems that are very topical now. One of the main problems that was clearly identified in that study was the lack of competitiveness convergence. So that was, I must say, unexpected for us. but we have realized that and this immediately triggered action at the level of the euro groups – the group of ministers – of economic and finance ministers – of the euro-area countries. So there is now a much deeper surveillance of competitiveness issues amongst euro-area countries.

The issue of internal imbalances that Angel refers to – internal balances within the euro area took also much more importance and is much more deeply analyzed now than it was in the past. So and clearly the issue of – again that Angel mentioned – of fiscal discipline in good times, in our rules-based system was very much focused – was too much focused – on bad times, so on this 3 percent, but neglected the handle – I mean, the fiscal policy in good times. So these fiscal surpluses that should have – primary fiscal surpluses that should have been prevailing.

So we took account of all that and this is being put into the – this has led to broadening and deepening the surveillance both by the peer group and also by the commission that has adjusted in order to make this – so I mean, we learn from our errors. We couldn't have anticipated all the situations that have prevailed, but there is – with all

the frustration that an official – and probably also external observers – can have – but there has been adjustments and so far, the EU politicians have been up to the challenge.

So now, more precisely on Greece, on the current situation. So it is clear that we can think and we can speak, we can write about the possibility of the exchange rate as a variable to exit the prices in Greece. But as some said, forget about it. They are there. They are there and they are not going to leave because leaving would be a catastrophe for them. So they have no incentive to leave, so the problem is to have a credible recovery based on something that can be done.

But this means probably some help from the others, true. But all these decisions – both in Greece and outside Greece must be made in a political economy context. Therefore, it is for German populations and for other Euro-area countries – it is paramount that the Greek show that they have the determination to take all necessary measures to redress the situation.

And they can. They can and it seems that the initial opposition that surged following the – I mean, the first acknowledgment of the situation, opposition from the trade unions and from other quarters is now waning. There is much more conscience because there has been functions by the politicians – I mean, they took the responsibilities and explained to the public opinion that the situation was really serious. And so far they are overcoming those.

So if there is political will on both sides, the problem will be solved. This is what the heads of state and government last week came to the conclusion that with the appropriate measures by Greece, the appropriate measures would be taken by the fellow euro-area countries. So that shows that, I mean, once more that the doomsday will not come, provided that there is that political will. And that political will seems to be there, therefore, the situation for the future is much less gloomy than some present.

MR. DADUSH: Thank you very much, Antonio. That was very useful. I'd like to conclude in just a few minutes, but if there are one or two more questions, I'm happy to take them. Yes. Yes, please. The gentleman there. Please introduce yourself.

Q: (Off mike.)

MR. DADUSH: Yeah. Hi Bruce. Sorry. I can't see you very well from far away. Yeah.

Q: Bruce Stokes with the National Journal. I'd like to ask both of you. There's some debate in Europe about what should be the role of the IMF in this process and whether it would be best to have a European solution to this problem or have the IMF more directly involved. I'd be curious to get both of your thoughts on that and also a judgment as to whether – what's in the U.S. self-interest? Would it be better for us to have the IMF involved with this? Or is it better to have a purely European solution?

MR. DADUSH: Very good question, Bruce. Anybody else? Yes?

Q: Juan Martinez, economic counselor at the Embassy of Spain. I just wanted to ask the panelists about a couple of things that I expected to hear from them and I didn't. I heard very little about debt sustainability. We have – like to hear about what would, you think, is the limit of the debt for a country like Greece or Spain or Japan? What's the role of expectations in this – all this mess?

Again, another thing that I was missing in the dialogue was a little more about structural policies and structural reforms, in the sense that while in the situation as we are discussing inside the euro area, one would expect to

discuss about what are the structural policies that are being implemented by countries in that area, because that would be a good element for judgment on the behavior of the countries in the long term. I mean, structural reforms could help a lot of – in evaluating the performance of the countries and just to help the markets to treat properly different countries.

And the third thing would be about the global imbalances and the potential growth. I think that one thing that this is somehow above all us is all this expectations of growth for the future for countries in the G-20 and specifically in the developed countries of the G-20. Is it possible for them to go back to the same rates of growth that they were experiencing at the beginning with China adjusting the exchange rate with the dollar?

Or is it just impossible for them to expect to have rates of growth above 3 percent, for instance, and they are, maybe, need to think of a different way of recovering in the long term, on a long-term basis? Thank you.

MR. DADUSH: Sorry, the last question was about the emerging markets or all of the G-20? The last question.

Q: The last question was basically about the developed countries, not the emerging countries.

MR. DADUSH: The developed?

Q: Yes. I don't have any doubt that the developing countries are going to experience huge rates of growth in the future. My doubts are related to the performance of the developed countries – all the euro-area members and all the European countries and all the developed countries in general. Thank you.

MR. DADUSH: Okay, I think we have a formidable array of questions here: the IMF, debt sustainability, structural adjustment, growth and global imbalance. So even with this formidable panel, I think I'll stop it there and ask Desmond to pick up where he wants to pick up.

MR. LACHMAN: Let me start with the question on the IMF. The Europeans have already accepted in principle the notion that there will be IMF involvement. And I think that basically what they are recognizing is that the IMF is better equipped than the Europeans to actually impose conditionality. They've got the technical expertise; they've been to this dance several times before. I thought that that's what is indicated in the communiqué, that the IMF is going to be involved in providing technical assistance. The IMF is already fielding missions to Greece; they have been technical assistants to Greece.

But be that as it may, to me this is a sideshow: Who actually finances it? I would have thought it's in the Europeans' interest to have the IMF involved, because that way, they'd be using partly United States' money to do the financing. But if they want to go their own way, they've made many poor decisions in the past; this would just be another one.

The issue of debt sustainability, I think, really goes to the heart of the matter. There was something called the Maastricht criteria, which seems to be obeyed more in the breach than actually in actuality, which sets a limit, both in terms of the size of the budget deficit as well as the level of the debt, precisely for this reason: to prevent countries from getting themselves into trouble not playing by the rules. If you just look at Greece's situation, Greece's public debt-to-GDP ratio is now approaching 120 percent. Its budget deficit has run above 13 percent, which is four times the Maastricht criteria, so debt sustainability is really at the heart of the issue.

My view – I've mentioned this enough – is for them to get back to debt sustainability. The only way they can do it in a fixed-exchange rate regime is by going the route of Latvia and having GDP contract by 15, 20 percent. I'd

actually be curious to know of a country that's actually adjusted a budget deficit by 10 full points of GDP and didn't have a major recession. It's not stopping the Greeks from presenting their projections. They're having a 4 percent adjustment and yet they're having a GDP not declining. Well, hopefully Uri will have this seminar next year and we'll discuss that again.

Last question: Just in terms of global imbalances and what prospects are for the emerging markets, it depends pretty much on what happens. If we get a slowdown in the United States, if Europe's got problems, if the globe is slowing, that's very difficult for the emerging markets to disconnect from that slowing; so that would really have an impact.

I think a troubling fact that I find in the current global situation is every country, every major country including that of the United States, thinks that the road to redemption or the road to recovery is increasing its exports, and unless we begin trading with another planet, that somehow doesn't work.

MR. DADUSH: Okay, thank you. I'd like to ask Angel to pick up on the questions and particularly on the question on structural adjustment, if possible, because we really haven't gotten into that.

MR. UBIDE: I promise I'll get there. Just let me say one thing: In case, for those of you who don't know, the European Commission basically does an Article 4 on each country every year. You know how many countries are in the euro area, how many years have been gone? I think the European Commission has doing 200, 300 programs in the last few years. So they do have the expertise to do it. I don't see why the IMF – and I worked at the IMF before – but I don't see what the IMF should be involved in here.

Again, I don't think the U.S. called the IMF to solve California's problem when they were issuing IOUs, and that was as close as a default as it gets. So I think in terms of solving the problem, the Europeans can do it by themselves and they will.

Now, on the difficult question, that is, what's the optimal level of debt or what's too much? And the answer is, we have no idea. I think the research shows tentatively that when you go beyond 90 percent, bad things happen. But I don't think that's something that we can really put too much weight on.

But what I think we are facing is essentially that the long term has become the short term. We are facing the crisis of the entitlement system. We have been kicking that can down the road, with the exception of some countries like Italy, for example, who did some good pension reform in the last few years and now they have a better situation.

But I think we are approaching the moment where the big difficult decisions need to be taken and nobody seems to be willing to do it. And that's, I think, the key problem that we are facing. Yes, there is a potential growth issue. There will be less leverage in the global economy; there was too much. Growing at 5 percent for several years in a row was probably a signal that there was too much leverage in the global economy, so we'll be growing below that. I don't know what the level will be. It will be below five.

But the question is, are the policymakers willing to tell the citizens, I'm sorry but the promises we made are not going to be fulfilled? And we need to find a way of solving that problem. And that's the key to structural reform that everybody needs to do. It's in the U.S., it's in the U.K., it's in Spain, it's in France – it's basically in every developed country at the moment. And that's the key issue. If you solve that problem, you solve the debt sustainability problem, basically at the stroke of a pen. But I don't know if we are collectively going to have the will to do it.

MR. DADUSH: Okay. At this point, if there are any pressing questions, we'll take one last one, and if not, I'm going to turn it back to the panel for a single message that they'd like you to take away from the discussion. Then I will summarize just very briefly and conclude. Any questions? No? In that case, let me ask Desmond if he has a single, very important takeaway message that he'd like to leave us.

MR. LACHMAN: No, I think I've said enough. I'll only just say, personally, that I believe in the power of prayer. (Laughter.)

MR. DADUSH: Angel?

MR. UBIDE: Just to say that I shared a panel with Desmond – I don't know if it was a year or two ago – and I thought he could never get gloomier than then, but he did. (Laughter.) So I'm hoping not to share a panel with him next year, then. (Chuckles.)

MR. DADUSH: Let me just say a word in conclusion that I am – I can say at the end, I'm more of the view that this situation will be managed with great difficulty and with serious implications for the growth rate of the most vulnerable economies for some years to come and possibly for European – for Europe as a whole. This will affect its growth rate. We are issuing something tomorrow where we've written something on this, before this panel, which will be on our Web page. There will also be a summary of the discussion on the Web page.

Let me say, just in conclusion that to me the greatest concern is not so much about default or the breakdown of the euro area any time in the near future, but how difficult it will be for the countries most affected to go back onto a moderate path of growth. That, to me, is the key. It is the key in Italy; it is the key in Spain, Portugal, Greece, Ireland as well.

And if you want to watch an indicator, I was taught early on, what is the indicator you're going to watch? The indicator that you will need to watch to see whether we are going towards a Desmond scenario or towards an Angel scenario is whether these most vulnerable countries are actually growing again in a year or two, because if they're not growing again, then the implacable dynamics of debt will assert themselves – the real interest rates and the big primary deficits, et cetera, just mean debt accumulation. And that will be a signal that something much more difficult may be lying ahead. Hence, the message about the importance for global growth to resume and for European growth to resume. That is the single indicator that I will be looking at, is the growth in these peripheral economies.

Let me close it there. Thank you very much for sitting here with rapt attention and I'd like to thank Desmond, who never, ever disappoints me in presenting the darkest possible side of the issue, although he always refuses that characterization. He thinks he's actually being quite evenhanded in his presentation. I'd also thank Angel for bringing also a lot of wisdom and perhaps a more, somewhat more moderated view. And thank you all for coming. (Applause.)

(END)