General Discussion: Setting Policy Priorities for Long-Run Growth

Chair: José De Gregorio

Mr. Zoellick: First, I want to briefly add my personal respects to Jean-Claude, with whom I have worked since the late 1980s. I haven't met anybody as wise and shrewd; he's also such an excellent gentleman to work with. Therefore, Jean-Claude, I have a question for you and Christine, if she would like. I'm concerned about risks of events this autumn. In particular, I can see a series of things—parliamentary problems with European Financial Stability Facility (EFSF), the Greek debt restructuring, or just the politics of the German Constitutional Court, deposits from money market accounts in EU banks, and there is always some other one that you cannot foresee.

I, of course, deeply appreciate the history of European unification, the political dynamics, and significant achievements. Nevertheless, events could trigger market challenges beyond the three small countries to larger countries or the EU banks. While the pace of alignment of fiscal union with monetary union is, of course, something that's up to EU governments, the gap will invite markets to intervene and all of us will be affected.

Now I suppose ECB bond purchases could always hold off a market challenge. But, as you know better than anybody, there are political limits to what you can say and perhaps to what you can do. Therefore, my question is, How can the eurozone and the IMF anticipate and manage this issue? Is this one of those moments, which we always talk about, when political leaders actually do have to get ahead of the curve? Are there things some of us can do to prod it?

I don't ask this lightly. Let me pose one issue of the derivatives of this. If there is a problem in the eurozone and the Fed extends the normal swap lines, we could find the United States in an election year being the major holder of European liabilities based on a crisis, and I am not sure how that would work out. It strikes me this is one of those moments we have a very serious issue. I know it's not easy, but people would benefit from having your views before we leave.

I have a very brief comment for Barry Eichengreen. I enjoyed your comments on China. It was interesting to me that the Chinese approached us at The World Bank last year, posing many of the exact same questions you have. We have been engaging in a yearlong piece of analytical work that goes beyond their Twelfth Five-Year Plan, beyond the what-should-be-done to how-to-do-it. I leave for China next week to have a discussion on the penultimate draft.

Now, of course, the devil is always in the details of implementation, but as I've listened to discussions over the past two days, I have to ask myself, "What's the odds the Chinese undergo structural reform for new-growth model versus the United States, Europe, and Japan," and I am not sure I would count the Chinese out on that.

Mr. Gurría: Thank you to the participants. The short-term addressing the banks as pending still unfinished business is of very great consequence. Christine mentioned, particularly in Europe, the cleansing of the balance sheets and then the recapitalization are still pending business, because we have to remember banks have other things to do other than not go broke. They also have to resume lending in full at some point and that is part of the medium- and long-term growth solution.

The question about the debt: Clearly here, you have two issues. Once you have the sovereign debt crisis, mostly in Europe, but then you have the debt issue, where yesterday we were mentioning the three different efforts. First, you have to stop the rot, so the debt stops growing. Second, you have to come down to a more comfortable level of total debt, so it doesn't affect growth, because the experts yesterday said after 85 or 90 percent it starts affecting growth. Well, we are there already. That's the problem! And it is still growing. So this is a very strong signal. Then the third is the question of aging will come and will require another consolidation effort. So we are talking about a generation, as we suggested. This is extremely critical.

How do you mix that with maintaining the élan for the growth, which is still very feeble and rather vulnerable? It's about signals. It's a language question. It's a messaging system. It has a lot to do with policies, but it also has to do with leadership and taking the market by surprise. And overshooting and saying, "Let's not just be chasing the market, but let's lead the market, rather than trying to satisfy the market or the rating agencies."

I also have to say that Jean-Claude mentioned the question of governance is like en passant. This is where the biggest deficit is today. This is where the biggest problem is today and I would say I don't think the greatest problem is in Europe. We at the OECD were based in Europe. Europe is dealing with it. Europe always has this big sign coming in saying, "Men at Work." It's a chantier. It is always rebuilding itself or reconstructing itself or reinventing itself.

I am more worried about the governance of the discussion about the future and the future sources of growth and even the shorter term in the United States. Because the United States has to have shoulders that are broad enough to sustain their own problems, but also the problems of the ***system*** to a very great extent is a very great concern. And we have to deal with that.

I will finish with just one question. We ran out of monetary room and we ran out of fiscal room, so therefore the solution is to go structural. And we have to go back to the fundamentals—to education, to innovation, to competition, and then go social—because there are still millions and millions and millions who are victims of the crisis and who will obviously require, even in tight budgets, that we deal with them, especially the young. We now have 20 to 30 percent unemployment and 40 percent unemployment of the young in some of the most buoyant and some of the richer countries in the world.

Mr. Sinai: This is for Ms. Lagarde. Your comments on balancing continued growth with fiscal consolidation and different for each country conceptionally resonate. Might that include a view of less-stiff lender conditionality on those countries that have ended up with a difficult sovereign debt problem? Sometimes some of us might think a self-reinforcing negative dynamic has been intense austerity in return for funds relief for troubled countries and financial institutions. Since deficits and debt objectives are expressed as ratios of GDP, achieving them as a result can be elusive. This may be especially true now in Europe, given the current crisis because of the interaction of slow growth in the United States, slowing growth in Asia, and a possible return to recession in Europe.

Mr. Poterba: Let me pick up on one of Madame Lagarde's remarks about how the government's balance sheet is a key issue right now, and link that to discussion of transparency. Banks have balance sheets and private corporations have balance sheets, but most governments do not have balance sheets that measure things in a consistent accounting fashion such as that used in most of the private sector. For example, the approach of retirement of the baby boomers in the United States does not generate a growing balance sheet liability for the government each year. Rather, we measure this with projections about debt-to-GDP ratios some number of years into the future, or with deficit forecasts for some number of years forward. This is probably not an issue for most of the central banks represented here, but it may be something the IMF can tackle and add more clarity to, particularly through something like the ongoing fiscal monitor project.

In the United States, not just at the federal level but at the state level, pension liabilities for retirees in the public-sector jobs have not been accounted for in the way they would have been accounted for had those been private-sector workers. Assumptions about rates of return on portfolio assets, and associated discount rates, are often higher than might seem reasonable. Constructing more transparent measures of fiscal balance sheets in the government sector, and also providing more education to policymakers and the public about how to think about them, may be a very important part of addressing fiscal issues.

Mr. Hatzius: I wanted to pick up on Ms. Lagarde's note that inflation risks are diminishing and monetary policy should remain highly accommodative and stand ready to dive back into additional unconventional stimulus. I wanted to get the views of the other two panelists on that issue please.

Mr. Frenkel: I have a couple of points. As Christine Lagarde emphasized so well, we have here a fundamental conflict between long-term needs and short-term urgencies. If long term means consolidation and short term means accommodation, then how do you bridge that conflict? Normally, one bridges such a conflict by having a package that includes the present and the future and basically trying to have in the package components that deal with both. But the necessary condition for such a package is that you have credibility. If there is one thing in which we have a great deficit—probably the greatest one—it is the credibility of policymakers. There is no question that in the midst of the crisis policymakers delivered and the London Agreement was an example. But the reality is there is a great deficit in credibility. The recent debate in the United States about a debt limit is only one example.

One of my concerns is, and I am not sure you know the answer, If everyone now looks with hope that in the United States there will be a program that shows and identifies how $1.5 trillion for cumulative deficit reduction over a decade, one may get into the habit of believing that is all that is needed. But it is *far away* from what is needed. If you look at the U.S. projections of the CBO, there you see with every 0.1 percent of growth *below* the previous assumption over a decade you accumulate $300 billion of an additional accumulative deficit. So, if you grow, on average, over the next decade by 1 percentage point below what previous projections were, we are talking about $3 trillion just from that, let alone interest rates that will be normalized to a higher level. The reason the issue of credibility by the very game of trying to stick to finding a solution to a problem which is a small problem relatively to the orders of magnitude.

Let me make one last remark. The issue is not macro. In most of the countries, the issue is really structural. Competitiveness in Europe is an issue of structural. Unemployment gaps between Germany on the one hand and Spain on the other really are structural. Just looking at the budget and monetary policy will really miss the point.

I want to make one point that Alan Blinder would have said if he accepted your challenge to speak. He gave us some numbers a few days ago. I will highlight them and finish the conversation. The greatest difficulty when you have unemployment is the group that has been unemployed for a long period of time. There the solution is very, very difficult. It is retraining, etc.

In the United States, a decade ago only 10 percent of the unemployed had been unemployed for more than 27 weeks. Three years ago, 20 percent of the unemployed had been unemployed for 27 weeks and above. Today, more than 40 percent of the unemployed have been unemployed for more than 27 weeks. This is not macro. Now we are talking about challenges to the structural, which means it's a very long-term issue.

Mr. Taylor: On the subject of maximum growth, let's remind everybody that we aren't adding any growth in the United States. This recovery is 2 years old. It is a recovery in name only. I think the reason for that is all of these policy responses. We have done one thing after another with short-term stimulus programs here and there, and meantime government spending has exploded from 19.5 percent to over 24 percent of GDP since the crisis began. So, I look at it as the problem is the policy. The best way to resolve it is to get back to strong maximum growth, say 7 percent, like we had in the recovery from the last big recession to try to get back to the consistent longer-term strategies that would work.

Here, just one comment. We've all been bemoaning the fiscal disputes in the United States. Well, something pretty significant was accomplished in the Budget Control Act this summer. Roughly speaking, a $6 trillion gap over 10 years had to be filled; it may be larger but $6 trillion is what the CBO has had. Between $2 trillion and $2.5 trillion of that has been closed, once this deal was finished, largely through spending reductions. There is a long way to go, but let's not discount $2.5 trillion out of $6 trillion, as a reflection this apparent cacophony and political dialog are actually starting to accomplish something.

Mr. Singer: I'll focus on Europe. I have one comment on Jean-Claude Trichet's presentation and one question.

The comment is the similarity between unit labor cost dynamic's. In Europe's, case it's driven by Germany and in the United States' case by the states which have a much lower meaning, so it is a bit misleading. As a suggestion, I think it would be nice to see similar comparisons for the fiscal situation in unemployment rates.

My question is, Doesn't the similarity between the dispersion of various macro indicators in the eurozone and the United States suggest the eurozone be in a similar fiscal state and other aspects as the United States?

Mr. Yamaguchi: My comment is a brief observation rather than a question to the panelists. In yesterday's discussion on public deficit and debt, there was a consensus this was largely a political process and therefore central bankers have the right to criticize and complain about the process.

As an ex-central banker from Japan, I found this argument a bit ironic, because the existing financial market conditions with bold and unconventional monetary policy not a small part of it appears to be providing a very huge disincentive for politicians to move seriously toward fiscal confrontation any time soon.

In my experience in Japan, I think it is rather natural for politicians to resort to a fiscal forbearance when they find financial market conditions extremely accommodative, particularly when they find the yields on government bonds at such extraordinarily low levels. Now obviously monetary policy had its own missions and objectives, and I believe that forcing politicians to move toward consolidation is not a part of the central bankers' mission. Therefore, the disincentive I am now talking about, partly generated by the monetary policy pursued by many central banks in the advanced region, should perhaps be regarded as one of the adverse side effects of accommodative monetary policy. It should not be taken as an indication to raise interest rates any time soon.

However, I can tell you that, when an extremely easy monetary policy is pursued for many years, as it has been in my own country in Japan, the said adverse side effects tend to grow. What I am now a little bit concerned about is that, as the central banks in advanced countries continue to pursue the present easy monetary policy and unconventionally easy monetary policy, the political pressure on central bankers to do more to help finance budget deficits may grow as well.

This may raise important questions on the central banks' communication policy and I am not going to go into that big question now. I would conclude by saying that, at the very minimum, I would hope central bankers remain very cautious when they talk about future monetary policy, not to raise excessive expectations for politicians they may get something more from central bankers.

Mr. Bergsten: I cannot resist saying to John Taylor that the sharp U.S. recovery from the deep recession of the early 1980s had something to do with the largest Keynesian stimulus in the history of the United States, carried out by the Reagan Administration. My question is to Managing Director Christine Lagarde, but I would welcome Jean-Claude's comments as well.

Madame Lagarde, at the end of your remarks you called for international cooperation and cited the role of the international community. Do you and Jean-Claude see a role for the upcoming G-20 Summit in trying to forge mutually reinforcing cooperation among the major countries to achieve the objectives you cited? Clearly, the G-20 Summit in London in early 2009 played a very important role in the recovery from that crisis. But the coordination impetus has declined sharply. Do you believe we need it again now and would you call for that cooperative element as being perhaps an essential ingredient in achieving what you've challenged everybody in your remarks today to pursue?

Mr. Eichengreen: Jean-Claude's interesting presentation deserves at least two remarks. One is that the data on which his contrast between the United States and Europe are based are likely to be revised. The data as they currently exist show that the United States outperforms because of service-sector productivity. We have learned in the course of the last three years that some of this supposed service-sector productivity growth was an illusion. The statistics were contaminated by overstatement of the output of financial services. More generally, it is important to remember that service-sector productivity is notoriously difficult to measure.

Secondly, I worry about the unit labor cost comparison. In the United States, we saw unit labor costs shoot up in Alaska and Louisiana because of high energy prices and the consequent ability of energy producers and others to absorb higher costs. The European problem of divergent unit labor costs is more complex and more troubling.

Madame Lagarde made the key point: the need to distinguish the importance of short-term fiscal support for the expansion from the need for medium-term fiscal consolidation. The argument for short-term fiscal support is fully intact. So is the argument for the importance of longer term fiscal consolidation. Jacob Frenkel asked the question: How do you reconcile the two? The answer in three words is "institutions and procedures." Countries need independent fiscal councils, more agenda setting power for the finance minister or prime minister in the annual budgetary round, and binding fiscal rules where procedures alone don't suffice. Take the Spanish case. A debt brake or a balanced budget amendment is appropriate for their political circumstances as a way of dealing with the medium-term credibility problem, so long, that is, as it is implemented in a way that doesn't turn automatic stabilizers into automatic destabilizers.

Finally, because Bob Zoellick asked about the immediate crisis, I will take 30 seconds to give you Eichengreen's four-part plan for resolving Europe's crisis.

1) You need Europewide uniform standards and regulations for banks. Enough already with the nonsense of a single currency, a single financial market, and 17 separate national bank regulators.

2) You need a Euro-TARP. Again, I think Madame Lagarde indicated how you could harness EFSF and turn it into a proper engine for bank recapitalization.

3) Debt restructuring where it is appropriate.

4) And—because Jan solicited my opinion—there has to be more monetary support for the recovery.

I would close by mentioning that my four-part plan did not include the word "eurobonds."

Ms. Lagarde: I'll focus on those points that were directly addressed to the IMF. I think the first one had to do with this complex dilemma that I've tried to explain in about the medium-, long-term fiscal consolidation with the necessity to allow for some space for those that can afford it to actually encourage growth. You actually derailed into well, what about those conditionalities in some of the programs that have been put in place so far? I would argue that, in respect of those existing programs and programs coming for the future, we need to be extremely realistic about the baseline and we need to be extremely realistic about the targets. That will be our way to address the combination of medium-term fiscal consolidation, yet allow room for growth-supportive and growth-inducive measures.

The suggestion we study the proper recording and accounting of some of the liabilities incumbent upon governments and upon nations in our fiscal monetary report is a good idea. Whether we are talking about pension liabilities, whether we are talking about health-care liabilities and the growing liabilities as a result of the aging of population is one that needs to be taken into account. And I will gladly take that recommendation.

If we come to assessing how we account for debt as well, it would be an interesting factor, because as you know debt is accounted in a different fashion whether you look at a corporate budget or at a government budget.

On the point raised by Jacob Frenkel, I could not agree more. That is exactly what needs to happen — a combination of the short-term imperatives and the medium- and longer-term necessities packaged into something that actually gives, foremost, a perspective. I think a lot of public opinion needs to understand perspective. That goes to your point about successive sorts of piecemeal policies that do not actually map out to a perspective that people can actually understand —where they can see the future and their dreams for their children, etc. That relies very heavily on the credibility of those that promote those packages.

To jump into Fred's questions, to the extent individually some of the leaders have not the degree of the level of credibility at the moment to support that long-term view and that package deal you referred to, Jacob, it is probably a good idea to group that credibility into a collective view that has taken, for instance, on the occasion of a G-20 meeting that is coming up in November. Reinforcing that collectively—and I am not going back to the sum is better than the addition of the parts—but there is an element of that about it. If there were the same level of momentum and impetus as a result of the upcoming November G-20 meeting as there was from the London meeting, that would go a long way in convincing people, public opinions, analysts, and markets that, yes, there is a collective drive to address the issues in a concerted and comprehensive fashion.

I've addressed those issues that directly refer to me. I will leave it to Jean-Claude Trichet to address Bob Zoellick's questions, but by the same token I would like to also add my voice to those who have complimented and elevated Jean-Claude as the ultimate central banker and one who has actually faced huge crises in a visible and also very invisible fashion behind the scene in a very efficient way.

Mr. Trichet: On monetary policy, which was addressed implicitly or explicitly by Barry, let me remind us the way the (ECB) Governing Council looked at it. We make a very clear distinction between what we call the standard measures—namely, the interest rates—and the nonstandard measures. Standard measures, interest rates, for us have to be designed in all circumstances to deliver price stability in the medium run. We consider that the very solid anchoring of our inflation expectations is one of our major assets.

It has been preserved since the setting of the euro. It has been preserved through all the turbulences we have experienced and are experiencing. And it is something which we consider absolutely essential for confidence in Europe—confidence of the people—as an independent institution we are accountable to the people; confidence for the people in their own price stability, confidence in the central bank. Confidence of the households as well as confidence of entrepreneurs and savers in solidly anchored low future inflation help considerably in difficult circumstances to preserve appropriate growth in the economy.

If we were not solidly anchoring inflation expectations, I would expect the nominal medium- and long-term market interest rates—whatever the level of the different spreads would be higher because they would all incorporate the additional increase of inflation expectations.

That being said, we very clearly make the difference with regard to the nonstandard measures and I would draw your attention to the fact that we have a very, very important nonstandard measure that we decided in its principle at the very beginning of the turbulences, which is the concept of full allotment at a fixed rate. We have decided to pursue full allotment at a fixed rate for the fourth quarter, on a one-week, one-month, and three-month basis. We even decided to have a six-month refinancing full allotment at fixed rates. For those who have concerns about the banks in Europe, and I fully share the view that was expressed by a number of interlocutors that our call is for them to reinforce their balance sheets, as much as possible. That being said, when I compare the level of eligible collateral and the level of collateral which is utilized, the eligible collateral is a multiple of what is utilized.

The idea we could have a short term liquidity problem in the euro, I say that en passant, is simply wrong—very fortunately, absolutely wrong—because of the non-standard measure we have taken. Also part of the non-standard measures is the purchase of securities: covered bonds on the one hand—the first such program ran from mid-2009 to mid-2010—and treasuries on the other hand, which is an ongoing program.

Now let me turn to the banks again, because it is a very important point. The European decision-making process might be difficult to understand, because Europe is not a political federation and its structure is complex. In a way it is history in the making, as far as institutions are concerned. We just created the new European Banking Authority (EBA). We have created an entity—the European Systemic Risk Board (ESRB)—which is designed to help prevent systemic risks. We *are* in the making. The ink is not dry on the decisions which were taken on July 21, 2011; they have to be rapidly and fully implemented. It is understandable that the international community looks at EBA as if it were already in place, an established configuration which was only late in making its decision. But the process is obviously very complex. Again we are observing history in the making.

All advanced economies are deeply challenged by the crisis. The "business model" of the United States, of Japan, and of the United Kingdom is under question. The euro area is also deeply challenged. Paradoxically, not necessarily the euro area as a whole. Because our fundamentals at the level of the whole of the Euro area are good. For instance, we have at the end of year a consolidated public financial deficit which would probably represent around 4.5 percent of the GDP, compared with two times this percentage in the United States and with Japan.

The problem is that we are challenged *in our governance*. I fully agree with Angel Gurría. This is the key. This is the reason why, Governor Singer, when I say there are dispersions of various indicators in the different States, of the United States, I don't conclude the Europeans can be complacent. I concluded on the contrary that we have to considerably reinforce governance, because we cannot wait quietly for convergence to operate spontaneously.

Convergence will not operate naturally, spontaneously. No. A single economy of the dimensions of Europe will necessarily be diverse, whatever happens, as the dispersion in the United States—is strongly suggesting. So we have to ensure for appropriate handling and governing of this diversity.

To Bob, I have already responded that it is history in the making. When I compare where we stand now with where we stood at the very beginning of the crisis, it's clear a lot of things, which were unthinkable, are now in the making. So from that standpoint, it is only confirmation that Europe started its own construction almost two-thirds of a century ago, after World War II. This process continues. Of course, this crisis of the advanced economies is a *formidable* challenge, particularly for those who are still making history. I would very much like to share the view you expressed, Bob, that from the outside it very often appears as if we are behind the curve and there are so many important advantages in being ahead of the curve so it's a pity to be behind it.

I fully share that view. Simply again, it is a very, very important historical process when seen from the interior. To the participants at this symposium, I would say that those who are underestimating the ultimate determination of the European democracies and of the European leaders to cope with the present European crisis are wrong in my opinion. It is always complex to go through all the democratic processes of 17 countries. But the conviction and determination of the leaders are there, in my opinion.

The main problem we have is clear. In the dramatic crisis that the private-sector signature had in 2008 our economies were about to collapse. We have to remember that. If it had not been contained by central banks and arrested by governments we would probably have had a depression which could have been more dramatic than 1929. Of course the public signatures of the sovereigns had to be fully involved. Now the real problem we have is precisely the credibility of the sovereign signature and this goes back to Jacob's comments. It is the creditworthiness of the public signature which is at stake. I have to say that the ECB has been very much on record to guard against the possible loss of credibility of the sovereign signature. We told governments: "be careful, don't say that it goes without saying that in all cases you have to spend as much as you can, and you have to engage in deficits as big as you can." It was more or less the global motto at the very beginning of the crisis in 2008 and beginning in 2009. Now we are paying a high price for that. There are only a few public authorities and public signatures at the moment without any doubt in terms of their credibility. We have to preserve and restore the full authority of the public signatures which are the ultimate backstop.