Adam Posen: Okay. Good afternoon, ladies and gentlemen. That is better. I’m Adam Posen, president of the Peterson Institute for International Economics. And it is my singular pleasure to introduce our esteemed staff for our semi-annual global economic prospects meeting. Thank you all for turning out today. This has become one of the features of the Institute's calendar, something we look forward to internally and I think many of you externally look forward to. And it’s not just fun; it’s useful.

We provide the kind of insights that I don’t think for all our friends in the official and for profit forecasting community do, we provide a set of independent insights that I think usefully and importantly supplement what you’re all thinking about the global economy.

So just to remember for future before [inaudible 00:54] so twice a year within a couple of weeks before the following spring bank meetings, bank fund meetings. We’re going to be here trotting out our global economic prospects meeting. We'll look forward to seeing you each time.

We’re now under the leadership as far as this goes of David Stockton who many of you know and in fact is the star attraction. David was, of course, for 11 years the chief economist and head of the Division of Research and Statistics at the Federal Reserve Board. We now share him. He’s a senior fellow here and also a senior adviser at Macroeconomics Advisers. And we’re delighted our good friend, Larry Meyer, who he and I tagged back and forth on David’s sleeves is with us today to kibitz a bit perhaps.

But we’re also to make this forecast run, our drawing on all the regional expertise, all the country expertise, and some of the issue expertise that the Institute has in its staff. Every time we meet, you should expect a statement about the US outlook led by Dave talking about the US forecast over the next two to three years and related issues. And you should also expect a speech or presentation on China usually by the inestimable Nick Lardy at least every other time.

But we also try to feature and bring out regions and risks and trends that are not necessarily in everybody's direct line of sight. And so every time, we’re also going to have two topical presentations. Many of you know this before, but we have jazzy new Institute PowerPoint format so I wanted to get it out there for you all to have this drilled into your heads.

Just to beat the point home, we usually get right some things that the consensus misses. So just to speak about the last time we gathered which was November 8th, Dave came out and said the US housing recovery is for real this time. Inflation isn’t a threat. And the fiscal cliff won’t happen. Nick presenting on China said, “Well, we’re not yet at least in the middle
income trap for China and that there is a reform path the leadership can take that will keep growth up in the 8 percent range.”

And I was here talking about the euro area being not going anywhere, not disappearing, no crisis, but being bounded above and below by the policy changes meaning more severe recession in southern Europe than the European Commission was forecasting at the time. And that set of forecast looks pretty good so far. Those were important voices to be heard. You should have listened to us. And so let’s tell you what you should be hearing today.

So, first off as I mentioned would be Dave Stockton. He’s a senior fellow here. And we’ll be talking about the US outlook. I promised my staff—not my staff—my team, our teammates, not to give away their punch lines. So Dave will say something about the Fed.

Then we’re going to have Barbara Kotschwar who’s a research fellow here at the Institute. Barbara joined us a few years ago from the Inter-American Development Bank. She’s been very active in our trade program coauthoring with Jeff Schott recently on TPP. But her real expertise and love is Latin America. She’s currently doing a very interesting project for us on Latin American infrastructure development and has a book coming out in a little while about what happens next in Cuba, which may give you some hints of kinds of things she’s going to talk about today.

And then finally, we have the man who has become to Europe in Washington what Nick is for China, Jacob Funk Kirkegaard. Jacob is, I’m proud to say, as I know Fred Bergsten joins me, is our homegrown talent of this generation and is now a senior fellow and also a rock star. Many of you hear him regularly even if you can’t avoid it on NPR, MacNeil/Lehrer, and so on. And Jacob is going to tell you some variant of the fact that everything’s all right in the euro zone which is, of course, his standard position.

So the way it’s going to work is each of our presenters is going to present in order. We’re not going to take questions at the start. And then the three of them will join me up here and we will take a finite number of questions from the floor, but first if I could ask Dave Stockton to come up.

David Stockton: Thank you, Adam. It’s a pleasure to be here today. I tried not to take it too personally when Adam scheduled the global economic outlook meeting for April Fool’s Day. But for those of you familiar with economic forecasting that might seem entirely appropriate.

So what about the US economy? I think there are signs that the US economy now is slowly gathering strength. I think it would be probably inappropriate to describe it as an inflection point that will probably give it a little too much drama. But I do think we are experiencing some springtime for the US economy.

But one of the messages that I want to convey is that as springtimes go, this is going to be a little bit more like springtime in Bangor, Maine than springtime in Atlanta, Georgia. It’s going to have some hot spells and some cold spells. And it’s going to take a while and we’ll always feel like it’s forward progress. But I think by late in the year, I think, we’re going to be feeling and experiencing something that feels a little bit more like some entrenched momentum in the economy.

So my outlook is for some modest pickup in activity and in the context of an inflation outlook where inflation is moving up a bit, but remains below target throughout the next three years.

For those of you who were here in November, you’ll note that the 2.3 percent that I’m forecasting for 2013 is exactly what I was forecasting in November, but that isn’t because things
had turned out exactly as I expected. In fact, I’d say the underlying data on the private sector for the US economy has been stronger than I had anticipated.

As Adam just noted, I was not expecting that we would go over the fiscal cliff that that was going to be headed off. But I didn’t think we’d also be getting as much restraint from the sequester. I expected that would have been replaced with something a little less restrictive.

But our net is still looking like an improvement relative to the experience of last year and enough of an improvement over the course of 2014 and 2015 to keep the unemployment rate on a slowly gradually declining path. And as the slack gets taken up in the economy, I do expect inflation to edge up. But I would expect again that we’re not going to reach the Fed’s 2 percent target over the course of the next three years.

So the outlook for the US economy is sort of occurring in a global environment where I think the activity outside of the United States is going to be neither a significant support—provide a significant support for the economy or impose significant drag on the economy.

Jacob is going to be talking about the euro area. But basically, his outlook is that things are going to be flat there on that for this year and with a little bit of improvement thereafter. I think incoming Governor Carney is going to have his work cut out for him in the United Kingdom where there is a significant amount of fiscal drag and still considerable impairment in credit markets that are going to be holding back activity there. There will be some improvement over the course of the next couple of years, but still a pretty soft story.

In Japan, maybe some improvement this year, given both the fiscal policy and monetary policy in Japan providing a boost, but growth probably running 1 percent over the debt course in 2014 and 2015.

China, maybe 8.5 percent. My colleague, Nick Lardy, would want me to make sure I indicated that the risks of that outlook are weighted to the downside.

Other emerging and developing economies, I think it’s going to be a mixed bag, but generally solid unspectacular growth. And Barbara will be shortly talking about a region in the world, Latin America, where that mixed bag really is very apt descriptor.

So the bottom line for the external sector is, I think it’s going to be a neutral for growth this year, probably a small plus in 2014 and 2015. The real improvement for the US economy is coming in the private sector and particularly the household sector where we’re seeing some genuine ongoing progress.

Plotted two series here, the blue line is the household financial obligations ratio which is basically a debt service burden measure supplemented with rental payments, insurance payments, other kinds of very, very periodic payments that must be made. You can see there’s really been dramatic improvement here. We’re back to levels that we haven’t seen since the mid 1980s.

To be sure, some of that improvement occurred because households walk away from debt that they had incurred. Obviously, the low interest rate environment that we’re currently experiencing is helping there. But even if you were to plot just debt to income, it’s also come back down. And we’re seeing very significant signs of improvement in terms of overall consumer loan performance where delinquency rates are at the low for this series, a rather dramatic decline. And I think that’s going to be providing some wherewithal for pickup and spending over the course of the next couple of years.
This slide is focused on the liability side of the balance sheet, but the asset side of the balance sheet, household balance sheet, is improving as well. Of course, a big part of that is the improvement that we’ve had in the stock market of late. But we’re also seeing improvement coming about through the housing sector.

I think in November, I posed the housing recovery as a question and I said I thought indeed that we were experiencing a recovery. I think the subsequent data have tended to support that—provide considerable support for that. House prices have increased rather dramatically over the course of the past year by either the Case-Shiller or CoreLogic house price measures.

I would think those price increases are likely to slow over the course of the next few years not retraced, but just simply back off the current high pace that they’ve had in part because there is a significant shadow inventory of homes. Homes have been kept off the market by people who have been waiting for the housing market to improve. And now that that improvement is occurring, I think we’ll see some of those houses come back onto the market and price increases will moderate some from where they’ve been.

We’re seeing the benefits of that firming in house prices and firming overall in the economy, but especially in the house prices and in terms of housing activity where housing starts have moved up. And you could see until about six or eight months ago, it was really unclear whether we were just seeing some noise in the data or actual ongoing improvement. I think now it’s pretty clear that we’re seeing a significant improvement.

And we’ve got a long ways to go because the equilibrium housing starts to account for increases in household formations, trends in second homes. Demolition is probably close to 1.6 million. And my expectation would be over the course of the next three years that we begin to move towards that, although we don’t reach 1.6. This forecast is predicated on a 1.5 million unit pace in 2015. So there is still a ways to go for the housing recovery.

And obviously the improvement in house prices is not just providing impetus to construction activity. But I think it’s helping out on the household wealth in terms of providing again some opportunities for greater spending. There are fewer mortgages that are underwater and that therefore would be the opportunity for households to refinance those mortgages, reap those benefits, and probably improving the overall lending picture. So I think housing has certainly been a significant plus for the economy.

What about other production indicators? I mean a lot of people have been, I think, quite excited about some of the recent strength in the labor market and industrial production. I think it’s encouraging, but I don’t think we’ve yet seen any clear breakout and I don’t think we’re going to for a while.

In part as you can see on the nonfarm payroll picture to the left here, what we’ve seen thus far we’ve seen a couple of times previously during the course of this recovery, and it doesn’t really look like it’s anything especially. I will admit that at the recent decline in the initial claims for unemployment insurance have been especially encouraging, but it’s just too soon to view this as signs that we’ve clearly had a turning point in the US labor market.

The same thing for industrial production, we’ve had some strong readings of late. But again, we’ve seen that at least several times before over the course of this recovery that didn’t actually extend. And this morning’s readings from the ISM survey of purchasing managers which dropped back down from close to 50 suggests that there isn’t some building momentum going on in the industrial side. So I’m not too jazzed just yet about some of the recent strength in the readings that we’ve got.
There’s a more fundamental reason for not yet getting too enthusiastic despite the fact that the first quarter is looking like it’s shaping up to be pretty strong and that is fiscal policy. We’ve had a significant swing from fiscal stimulus to fiscal drag. To be sure, the state local governments which have also been a big drag are probably moving more towards neutral now. But we’re looking at something like 1.5 to 1.75 percent fiscal drag this year.

Many people have been very, I think, encouraged by the fact that consumer spending has held up so well as it has after the payroll tax increases and the marginal tax rate increases earlier this year. At this point, we have a preliminary reading on spending for February. We don’t really—I don’t think we can take too much confidence yet that that is going to somehow be easily absorbed by the US household sector. It’s a pretty big hit. And we haven’t begun, even begun, to see the macroeconomic effects associated with the sequester which went into effect at the turn of the month.

And to think that again that amount of fiscal drag will not show through to overall activity, I think, is too optimistic. So I’m expecting in fact this fiscal restraint is going to show through in a weaker middle part of this year probably starting in the second quarter, but extending on probably into the fall.

So much of the public discussion here thus far has been, “Geez, the sky is falling. The sequester is going to create a massive amount of economic disruption,” to the, “No, it’s not falling. Everything is going to be just fine.” The macro part or there may be many micro disruptions, but the macro part of this is going to be some significant restraint on activity that we have yet to see.

Which brings me to monetary policy because I think the drag associated with fiscal policy is certainly one of the important factors in why I think monetary policy is going to be looser for longer than most people currently anticipate. And that’s an important element in my forecast, not just following along the forecast but actually providing some support to activity into the acceleration activity that I’m expecting.

So in the funds rate, of course, the Feds told us their thresholds were rate high, which are unemployment crosses 6.5 percent, inflation one to two years ahead is projected to move above 2.5 percent. Given my forecast, we don’t get to 6.5 percent unemployment until the very end of 2015 and that’s when I would expect the first rate hike to occur. And on the inflation side, not only do we not get to the 2.5 percent threshold; we don’t even get to 2 percent at least in my forecast. So I think we’re not likely to see any move on the funds rate until late 2013. Now, they call these thresholds not triggers. I do think probably when the unemployment rate moves below 6.5 that the Fed will begin to move.

On asset purchases, the Fed has indicated that it’s going to continue its program of asset purchases until the outlook for the labor market improves substantially or unless the costs are judged to exceed the benefits. So what are the costs that they’re looking at?

Obviously, they’ve noted three costs; one, financial stability. Here I think certainly they’ve pointed recently to some increase in concern about the corporate bond market and some areas where corporate bond covenants look like they’re weakening some. Farmland prices have been increasing rapidly. There’s not a whole yet, however, to indicate that there are significant instabilities developing in the financial market in a dimension that would cost the Fed significant problems.

Another issue the Fed has raised is the difficulty of exit from its current policy of accommodation. You know that there are some technical issues. I do not think the Fed is going to have any difficulty engineering restraint when the time comes. I think in fact they’re going
to be able to do that, maybe not smoothly, maybe not without some bumps, but I think
they would be able to do this.

Remittance is to the Treasury and the fact that when the Fed in fact starts its program of
withdrawing monetary accommodation that the remittance to the Treasury will go down.
I think this is just a purely political issue that the Fed is going to be able to manage. And I
don’t really see this as a problem.

Another one that the Fed hasn’t mentioned but you hear occasionally is one of the costs
the Fed’s combination is its impaired discipline on fiscal policy. But I think that concern is
entirely misplaced. The Fed should not be the job of the central bank to try to impose dis-
cipline on the fiscal authorities.

And my colleagues, Adam Posen and Tomas Hellebrandt, have a very nice paper actually
looking at the relationship between monetary accommodation and the success of fiscal
consolidations. And they find in fact that monetary accommodation increases the probabil-
ity of success of fiscal consolidations. And in some sense that makes sense in the context of
a stronger economy. It’s going to be easier to achieve that consolidation. So I don’t think
that’s a very convincing argument.

On the benefits, I think the Fed has provided considerable support to the economy
through easing financial conditions. Joe Gagnon here at the Institute has estimated pretty
sizable effects in terms of the Fed’s large scale asset purchases on financial conditions. And
my colleagues, Antulio Bomfim and Larry Meyer, and Macroeconomic Advisers likewise
have come up with pretty big estimates. So I think the benefit cost ratio still looks pretty
favorable to the Fed.

You know we’ve all seen those replays on TV of the football player streaking down the field
and spiking the football thinking that he’s in the end zone only to find out that he’s fum-
bled it on the 10-yard line. So the Fed isn’t going to make that mistake. I think they’re go-
ing to carry that ball across the goal line. They’re going to turn around and look to double
check that they’re in the end zone before in fact they put that football down.

So I think we’re still looking at pretty accommodative policy. And one of the big reasons is
there’s a huge amount of slack remaining in the labor market. So the goal line is still a long
ways off and the motivation for accommodative monetary policy is pretty large.

You know the Fed often describes its concern about the labor market in very human terms;
compassionate, we want that to be the case. But there’s a coldhearted calculation going on as
well, which is with the 2 percentage point unemployment gap, we’ve got a 4 percentage point
output gap. That’s $550 billion of loss output per year. So the motivation is pretty significant.

What about the Fed’s other aspect of its dual mandate? What about inflation? There just
isn’t any inflation problem at present. Measured by core PCE, inflation has been well below
the 2 percent objective. Measured by total PCE, inflation has been below the 2 percent ob-
jective. Measured by unit labor cost, a measure of business cost pressure, we’re at 2 percent
recently, but we’ve been mostly below 2 percent. So I don’t think that is going to be a con-
straint in the Fed any time soon.

Finally, you might ask this is true. This is all backward looking, but what about when the
economy begins to improve? I see very little risk from declining slack and that we’re going
to get an upsurge in inflation from an improvement in the economy.

And here you can just see the most recent period 1985 to 2000, inflation has become
much less sensitive to movements in overall labor market slack that was the case previously.
So even if we get a more substantial drop in the unemployment rate, I think the upside risk to inflation is relatively minimal.

And what about stable inflation expectations or our concern in inflation expectations might take off? So here I applied both the market-based measure and a survey of economist. You could see there really hasn’t been any movement to speak of in an adverse direction. The thing that I’d really want to call your attention to on this slide is not the most recent observations, but this is 12 years of data on inflation expectations.

In 12 years, we had 09/11. We had two recessions; one small recession, one great recession. We’ve had two recoveries. We had a housing bubble. We had a housing bubble burst. We’ve had some significant increase, a substantial increase in the Fed’s portfolio. None of that has had much of an effect on inflation expectations why in the next couple of years would we have [inaudible 23:01] of inflation expectations in the environment that we’re currently anticipating seem small.

So in closing, I’d say I’m pretty comfortable with a forecast in which there’s some underlying improvement and healing on the private side of the economy, some decline in the unemployment rate, pickup in inflation. And whereas I’d say over the last three years, I’ve characterized my forecast as having more downside risk than upside risk. I’d actually characterize those risks now as reasonably well balanced for the first time. So I’ll stop there.

Barbara Kotschwar: Thank you very much. And so on that somewhat positive note, we’re going to turn to Latin America. And as Dave mentioned, Latin America is one of those regions that’s been solid but unspectacular growth and a mixed bag. And I think that’s a pretty accurate description.

Latin America has done well in terms of growth for the past decade averaging in about 5 percent growth. The poverty rate is the lowest it’s been in three decades. And the middle class has grown by about 50 percent in the last decade. And so that’s somewhat spectacular.

But behind this growth, there are two Latin Americas. The region is split in terms of political philosophy and economic model between what we call the 21st century capitalist and the 21st century socialist. And we’re going to take a look at a number of events that might be marked as turning points, recent events which might tip the boat in some cases into more pragmatic economic policies and in other cases might consolidate the continuation of the economic model.

The first, of course, is the death of Hugo Chavez on March 5th, the president of Venezuela, who since taking office in 1999 has changed the political and economic landscape of his country, has had a significant impact on the rest of Latin America. And so what will happen to 21st century socialism after Chavez?

The second is Argentina which until about a year and a half ago saw a robust economic growth despite increasing inflation, despite currency pressures and rampant price distortions, protectionist trade measures, and being cut off from foreign capital markets. Despite these, investment, foreign direct investment has continued to flow into Argentina. Argentina has continued to grow. I think the Repsol expropriation marks our turning point. Obviously, the bond debt case which is being decided right now has some implications for Argentina.

Last in Cuba, Castro has put out an exit plan. Raul Castro is named as successor and set a deadline on his own administration. Another case is not a turning point in terms of economic model, but marks a turning point in the consolidation of a model. Mexico has seen
relatively unspectacular economic growth. The recent economic reforms undertaken by
the Peña Nieto administration may mark a turning point in that. So the mixed bag, Latin
America is mixed in terms of economic policy and economic development model.

The 21st century capitalists are the countries that have continued to implement the macro-
economic reforms listed in the famous Washington Consensus coined by our former col-
league, John Williamson. They've stabilized their macroeconomies, maintained prudent fiscal
policies while implementing policies to combat poverty, and enhance their social capital.
They're largely making efforts to integrate. InterGlobal supply chains, have environments that
are open to trade and investment, and observe the international rules of the game.

On the other side, we have the 21st century socialists led by Venezuela, which common
elements are populist policies, strong executive expansionary fiscal policy. Price controls,
ideologically, they tend to be anti-establishments. Several have engaged in significant na-
tionalizations or expropriation of businesses, probably the most famous being Argentina's
takeover of Repsol.

They're also less willing participants in international norms. In recent years, Bolivia, Ecua-
dor, and Venezuela have pulled out of the ICSID, the International Center for the Settle-
ment of Investment Disputes. And Ecuador currently has legislation pending that would
pull it out of the US bilateral investment treaty. See the bifurcated nature is reflected in risk
spreads. Argentina and Venezuela's CDS's are several basis points above the rest.

Delving into Venezuela, we expect no real change in political control when the elections take
place in two weeks. All signs point to Nicolas Maduro, Chavez's handpicked successor, to win
the elections. Will he be able to continue Chavez's economic policies? Maduro inherits or
whoever wins the elections inherits a different and much more difficult economic scenario.

Venezuela's GDP is lagging after growing by an average of about 10 percent per year. In
2004 to 2008, Venezuela has grown just under 2 percent in 2009 to 2012. This is despite
oil prices being high. Venezuela's oil prices are over $100 per barrel, yet Venezuela hasn't
been able to continue to grow. So, Venezuela continues to be dependent on oil, but oil pro-
duction in Venezuela has diminished by about 25 percent since 2001.

At the same time, Venezuela has not been a paragon of fiscal virtues saving while times are
good and commodity prices are high. In fact, budget deficits have continued to increase.
And one can expect more spending ahead of the upcoming elections and potentially after
that. Venezuela also currently has the fifth highest inflation rate in the world.

In February, the administration devalued the bolivar from 4.3 to the dollar to 6.3. It was po-
litically unexpected. Black market rates, however that's measured, has indicated that the level
is still relatively overvalued. This devaluation may be a sign of a shift towards more pragmatic
economic policies. It could also reflect the strength of the pressures on the economy.

So do we expect that President Maduro would be able to continue Chavez's 21st century
socialism given the economic environment in Venezuela? We expect that social programs
will continue probably with cuts, but that some of the other spending particularly on for-
eign policy will not be able to continue.

Argentina sees some of the similar pressures as Venezuela. Argentina grew robustly in the
2000s. However, economic growth is abating. Economic pressures include high inflation,
although that's not recognized yet officially how high it is. Declining foreign currency
reserves although still has $40 billion in reserves that has been declining and that leads to
pressures for a significant devaluation.
Political pressures are also starting to be seen. More and more people have been coming out to the streets banging pots. There's been decreasing union support. And unions have been one of the most robust supporters of this administration. The IMF has officially accused the administration of doctoring its data and has threatened punishment if this is not rectified. And the reason bond debt [inaudible 31:10] in New York seemed to add some increased pressure for Argentina.

Argentina throughout all of these has followed expansionary monetary and fiscal policy. Looking at the exchange rate and inflation rate, this is the official versus unofficial inflation. Inflation is increasing both in the official and unofficial measures. And so probably there needs to be some reckoning here.

The panel on the left, you see the declining reserves. Certainly it's not running out of reserves, but this is not a good trend. And the peso continues to be overvalued. So these are pressure points. Additional pressure points are the commodity prices which have buoyed the Argentine economy throughout the 2000s are tapering off. And you also see slower growth in Argentina's export markets.

Brazil is its main export market. Brazilian growth is slowing, China also. And despite Dave's predictions of some growth in the United States that probably won't be enough to pull Argentina up.

Mexico has been quite surprising in terms of what President Peña Nieto has been able to get done over the [inaudible 32:24] yet short tenure. Mexico's growth has been tepid over the past decade. The 2002 to 2010 growth was at about 2 percent despite low inflation debt and steady interest rates.

Recent reforms may boost this growth. Mexico has undertaken pretty strong labor reforms by making the labor market more flexible, education reform, which could overhaul its failing education system coupled with strong signs towards entrenched interest by, for example, arresting the head of the education union.

Telecommunications reform, the government estimates that this reform when it is implemented will add a percentage of growth to Mexico's economic growth. The big question is will the pact between the parties continue and enable Mexico to take much, much needed energy and fiscal reform?

Finally, reforms in Cuba under Raul Castro, Cuba has seen the most significant reforms in decades. They've loosen controls. Cubans are now able to travel without having to procure an exit visa. And you've seen some of these coming through Washington. Recently, cellphones are allowed. There's losing of the economic role of the state. There have been massive public sector layoffs and opening through private enterprise.

These are probably faster than Cuba watchers would have expected, but they're still quite slow. And so will Cuba continue to reform? Yes but with the continued relentless gradualism as some have coined this.

One question in Cuba is what would be the impact of the death of Chavez? Will that change the trajectory or the speed of reform? It might make the administration have to reform more quickly than they would have liked. And so that's something to watch.

Growth in Latin America as always is highly dependent on external factors. And so the growth of the United States, European Union, and Chinese markets will determine in large part how Latin America goes. Commodity markets are important.
And so whether these cases that we discussed are actual turning points towards more market-oriented economic policies, I would say yes, but with a caution that this will probably be a very, very slow and gradual process, probably not without bumps in that particular road as well. Thank you very much.

Jacob Kirkegaard: Well, thank you very much. Well I guess that I should start by saying that it's obviously a particular pleasure to be able to give this particular euro area outlook because I get to start by saying that my boss was right in everything he said six months ago.

But as the title which you'll see in a little bit indicates—I'm not going to tell you that everything is great in the euro area. But I will once again like I say that you shouldn't overdo the risks either. And I guess the way to think about that is just like during the election last year where one side of the political spectrum was told when it was worrying too much to take a Prozac and read Nate Silver.

Next time you read that, this time the euro is going to collapse. There's a 60 percent or 90 percent chance that this or that country is going to drop out. I recommend you read some of the work that we do here at the Peterson Institute; Adam, Anders Åslund, Nicolas Véron, and others because I do think you will get a somewhat more realistic view of the likely issues that will be facing the euro area.

So I want to give you a little bit about the macro outlook, although Dave stole a bit of my thunder on it. I want to talk a little bit about the European central bank. And then I want to talk about two key risks. And I should say that these are risks to the outlook. They're not necessarily risks to European growth where at least the first risk, the European Policy Consensus, was in fact probably by some, at least myself included, if that were to break that would actually probably be hopeful news for European growth. But it will be bad for this particular outlook.

And then I want to talk a little bit about the issues related to the establishment of the European banking union, many of which have actually been accelerated greatly by the recent debacle in Cyprus.

But starting with the macro outlook, in short, this will be another year of stagnation, which means that I would expect both the first and the second quarter, the recession in the euro area, to continue. And then in the second half of the year, we will see a very gradual recovery leaving us about flat for the year. And just going a little further into the future, I don't think we can hope for even close to 1 percent growth for the euro area next year either.

But I will also say that this is not an outlook that's going to be exacerbated or made worse by European Commission sanctioning of fiscally irresponsible countries. That's not going to happen. You are instead going to have, and you actually have had for quite a while I would argue, a focus on structural measures rather than the headline deficits when European fiscal policy is being made.

And this actually matters quite a lot because the way European fiscal rule should be interpreted today I would argue is not that you can never run a deficit more than 3 percent or for that matter whatever the European Commission deems feasible. The way it works is that it has given the European Commission some more political capital.

So when it gives a country the right to exceed the deficit target, which it gave Spain last year, it's going to give pretty much everyone that it needed this year. When it gives them that permission, it can extract some policy quid pro quo in return on the structural side. Which for instance, I would wager in the case of France, well, France is going to clearly
exceed its deficit target this year, it will be given a green light, but it will also be told to do a pension reform as part of the political price for that.

So therefore, ultimately, the EU fiscal policy framework is not in my opinion as rigid as many people believe, and therefore, also does not put particularly great further downward risk to this admittedly still pretty weak growth outlook.

Now on the European Central Bank, in short, I think it will remain on the fence or on the sideline. It’s not going to do very much despite the fact that I’ve just projected. In fact, they have in their own forecast projected another year of close to zero growth next year. The threshold for further rate cuts or the main policy rate is going to be extremely high. Zero growth, you know, below 2 percent headline inflation and very modest medium term inflation [inaudible 39:42] are not going to be enough in my opinion for this to change.

The main worry that the Frankfurt will have is the ongoing fragmentation in the euro area where I think it’s very clear that the OMT program has not been sufficient to reduce the de facto differences in the financing cost of the non-financial sectors in Europe between Spain and Italy where it’s still 4 to 5 percent easily for a loan and close to zero in Germany.

And in fact, as I’m going to talk about a little later, the events in Cyprus and the banking union actually has the potential to make this worse. But that does leave the outcome that whereas the ECB will not do anything on the main policy rates if they’re going to do something. And again I would stress here that the policy threshold is high for this to happen. It’s going to be on sort of more targeted so-called non-standard measures.

But again, I don’t think we should expect very large new non-standard measures because with the introduction of the OMT program, the ECB has essentially made itself hostage to political, the political response function in the euro area, meaning they’re not going to do something major non-standard unless they’re asked to do so by governments, which will only do so when the economy turns really, really bad. So essentially, monetary policy is going to remain very reactionary going forward.

Now on to the risks to this outlook, I think first of all, it’s important to understand that we may see dramatic television footage, Los Indignados in Spain, Beppe Grillo in Italy, Cypriot banks collapsing, etc. And you get the sense that, you know what, this policy consensus can’t continue. But the reality actually is that, you know what, this policy consensus can’t continue. But the reality actually is that it can in my opinion. And there is in my opinion no risk that the current policy of ongoing fiscal consolidation in the Euro area is going to change in the medium term.

Because the reality is, and I should say that I’m cognizant of sharing a podium that Simeon Djankov stood on just a few weeks ago. But the reality is that in the euro area at least you do not have popular protest lead to the overthrow of the government, which means that if you want to have a change of policies I would argue you need to look at the electoral calendar.

And if you start by the hegemon, Germany, and their sort of fiscal policy deputies, first of all in Germany no matter what the election outcome is going to be, it’s going to be status quo. Everything that has been done on fiscal policy as well as the euro area rescue packages since the beginning of the crisis in Germany has had 85 percent backing of the [inaudible 42:30]. That’s not going to change even if there is a surprise in the election in Germany and the new chancellor is [inaudible 42:37] so that’s number one.

And then all the other countries on that side of the column are going to be the same I would argue. Similarly, among the peripherals, Los Indignados is not going to cause the collapse of the Rajoy government. The Irish government is not going to change. And for
those who say that the Greek coalition is about on its last leg, I say yeah they don’t have a
great situation. But if you are PASOK and Democratic Left, the two left wing small parties
in that coalition, your choice is either to face an election right now vis-à-vis the SYRIZA
party or take your chances for a Greek recovery before the elections in 2016. I would wager
that they would do the latter.

So ultimately, you’re not going to have a major change among these governments either. And
you know just one last thing. Francois Hollande in France, he’s not a Keynesian. He’s not go-
ing to make—his election made zero chance of changes to the European fiscal outlook.

Then, of course, what about Italy? Well, I mean Italy, as someone who is a great fan of
Game of Thrones, I think studying Italian politics is even better because the season lasts the
whole year every year. But having said that, the reality is that political instability in Italy is
the norm, not the sort of, the abnormality. So where we are today is kind of where we’ve
been pretty much throughout Italian recent history after World War II.

The political system in Italy, therefore, is very robust. You know the threshold to go to
a technocratic government is quite low. Mario Monti was not a very unique experience
in this case in Italy. And as we should see later, I would argue that that’s my base case for
where we’re going.

The election result which I won’t have time to go into except to say that it really was the
big winner here was Silvio Berlusconi, not because he was running to be prime minister
but because he basically gets to stay out of jail and remain a main political character.

And I would also say that the election result places very significant question marks for
Beppe Grillo. He basically has to decide whether he would be the Occupy Wall Street
Movement ultimately in the longer term irrelevant or become the tea party movement and
integrate in the political process with a couple of key measures where he can really make a
difference. Where we’re going to be? I don’t think is really obvious yet. And then, of course,
Mario Monti was a big loser. He’s no longer a credible center-right candidate, ultimately,
the divided outcome.

But I think the prediction I would make is that we’re likely to have another technocratic
government, which would be led by another Monti-like character. My bet actually would
probably be that that person will be a woman this time because that’s the way the political
system in Italy can signal change without really changing very much without being very
cynical about it—sorry with being—thank you, Adam— with being very cynical about it.
And also maybe because neither Berlusconi nor Bersani is interested in having a new elec-
tion this would become the outcome.

But what it means for Italy is another issue of policy continuity. Monti’s fiscal tightening
stays in place. Structural reforms are not really going to happen. But more importantly
if the situation deteriorates, I would bet there will be a change or there will be a majority
among the currently elected Italian Parliament to make a request to the European Central
Bank. So again this is more of the same.

Well, then there are the issues surrounding the creation of the banking union, which I will
not have a lot of time to go into just to say that this is all very messy. And it actually does
have even though Cyprus did not blow up the euro area banking system, it does pose a
significant additional set of issues because you are messing with a very important element
of the European financial system. Because the reality is that most credit in the euro area
remains gone through banks.
This is a chart that shows you the balance sheets of the non-financial sectors in the euro area since the beginning of the euro area in 1999. And you can see the entire increase in lending to the non-financial sectors in euro area has actually come from the banks. Meanwhile, you’ve had very limited growth in the corporate bond issuance. And that means that where we’re going now with more billions which is something that I very much support. You know you protect insured depositors. You protect taxpayers. But it does come at the expense of putting additional uncertainties to this, the only channel of credit, really important credit intermediation channel in the euro area. And this matters in a lot of countries because a lot of these banks and a lot of these countries have actually relied on issuing bonds through finance loan growth.

What this chart is essentially the bank bond issuance which pretty much up until Cyprus enjoyed an implicit government guarantee on 1999 in the beginning of the euro and then the latest available data. And you can see with the exception of Germany pretty much every country actually had very significant increases.

Well, this is the type of capital structure, a type of lending by euro area banks that’s not going to come with a significant risk premium. And it’s going to come at a time when corporate bond markets remain very small, which of course again, clearly means that the SMEs in the euro area are going to be most at risk for an additional credit crunch.

So where does all these leave us with respect to the banking union? Well basically implicit in this outlook is the current implementation structure of the banking union, which means supervision and resolution agreed by mid next year, but certainly ongoing stresses, ongoing credit crunches.

But then I mean this being me, I do believe that there is actually ones as usual I should say a chance to rescue a success from this failure. Because what you do have and as I said this is I think 30 percent chance is actually an opportunity for a grand bargain so that the Germans having now imposed bail-ins on bank depositors everywhere in the euro area are now actually forced to therefore as a quid pro quo accept a joint deposit insurance fund for the euro area.

The ECB begins more aggressively to buy asset-backed securities of loans, securitized loans from SMEs and that eases the credit crunch. You have an abatement of the fragmentation; confidence is restored. And as you can see here, I think we have some upside on the growth. Of course, there is a downside as well, which is a small probability, but the macro-economic impact of that is actually going to be quite severe.

I don’t have time to go into the details of it, but it basically means that none of the issues surrounding the euro area policymakers on the banking union are going to be resolved. That will be very bad for growth this year and equally bad for growth or will be worse for growth next year. So I will end on that pessimistic note. Thank you.