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P R O C E E D I N G S

MR. ELLIOTT: Welcome, everyone. I appreciate your coming out to Brookings. I'm Doug Elliott from Economic Studies here at Brookings. And as you know, what we're going to be talking about, we're going to be examining the European Central Bank and its new role as it moves from the "Trichet era" to the "Draghi era." And obviously we should all wish Mario Draghi a great deal of luck since he is taking over as president of the ECB at a very critical time with the euro crisis in full bloom and some forecasters expecting a recession in Europe.

We have three distinguished panelists here today to present their views on the future of the ECB. First, Georges Pineau, who is on my immediate right. He can discuss the future of the ECB from a very solid background in the history of the ECB. Not only is he the ECB's permanent representative in Washington, he has been with the ECB since its creation. Indeed, he headed the division at the predecessor of the ECB and he worked with the forerunner of that organization. So I think he has a good grasp of where we are today based on where we come from.

To his right, Joerg Stephan heads the New York representative office of the Deutsche Bundesbank, which is probably the most powerful central bank within the Eurosystem. He has been with the Bundesbank for over a decade, joining that organization after a number of years working as an economist in the private sector in Germany.

And our final panelist is Don Kohn at the end. He is a senior fellow here at Brookings. He has spent many years working as an economist at the Fed, rising to be one of the few staff members ever to be named to the board itself. And rising still further to be vice chairman of the Federal Reserve Board until about a year ago when he came to join us here.

After each of our panelists speaks I will ask them a few questions and then we'll turn it over to you in the audience for a question and answer period. So we will do Georges, Joerg, and then Don. So let me hand it over to Georges.

MR. PINEAU: Thank you, Doug. Thank you for coming for this event which is quite timely, not only with respect to the change in leadership at the ECB but also in the broader context of the crisis and the aftermath of the crisis which has led central banks, not only the ECB, all central banks in fact to review the objective strategies and tools in order to draw some lessons from the crisis. And this review or this revisiting of the frameworks within which they operate is difficult because it is taking place under market and political pressure. Not in all countries but at least in the euro area.

And taking this approach, that is to look at the crisis and its impact on central banks and central banking in general, I would focus my remarks on three areas. First, monetary policy, of course; then, financial instability. Third, international cooperation, and fourth, the last point, I would like to say a few words on governance in central banking.

So starting with monetary policy, I would just quickly recount that from that start, that is in '98, the ECB was some sort of an outlier, somehow in between inflation targeters and the Fed, the Fed being maybe more of an outlier than the ECB because in part of its dual mandate. Why these ECB was not a typical inflation targeter, basically because we had this medium-term approach to pricability and also because we had the so-called monetary pillar and in the context of these two features, even before the crisis the position of the ECB with respect to whether to use monetary policy in order to deal with financial imbalances and asset price misalignments, on this issue the ECB was more open than other central banks like the Fed, for example.

You may know that even when we raised the interest rate in 2005, one factor which led us to do that was signals coming from our monetary pillar as we were aware of these growing financial imbalances. Admittedly, what we did in terms of raising the interest rate was not enough to protect us from further build-up in financial imbalances and we were hit by the crisis as much, if not more, than other economies.

And this led us to look for other tools to deal with these systemic risks or financial imbalances. And I will come back to this when I will speak about macroprudential tools and financial stability.

Let me turn quickly to the crisis and what we did. We did like most other central banks, that is using non-standard monetary policy measures. That is mainly using our balance sheet that is the size of our balance sheet and the composition of our balance sheet to address dysfunctional segments in the financial markets to provide liquidity as money markets were not functioning properly and also to provide credit to the economy. What we did a bit differently from other central banks is to, from the start, introducing this separation principle, which is to use interest rates, you know, to steal monetary policy and to consider the use of the nonstandard measures, this is the liquidity provision and other types of actions like asset purchases. We considered this as providing support to financial stability but in a narrow sense, in the sense of the transmission of monetary policy to the banking system, financial system, and the economy.

Just the last point under this heading is that before the crisis we had already a bigger balance sheet than the one of the central banks, and as a result even if we use the extensively nonstandard measures the impact of the crisis on our balance sheet has been smaller than for other central banks like the fed.

Turning to financial instability, before the crisis the ECB looked mainly at surveillance of the financial system through the Financial Stability Review. We were also involved in oversight of payment systems and we had also a role in providing service operating systems like TARGET2 and now we are developing TARGET2 securities. But our role there was rather limited and it was in line with the fact that the ECB was expected to contribute to financial stability. The ECB was not the main player or decision-maker.

With the crisis, of course, we contributed more to financial stability again through our non-standard measures and by providing stability to the monetary part of the financial system that is mainly liquidity provision to the banking system because the banking system is quite central to financial systems in the euro area, which is a difference with the U.S. because financial intimidation is going through banks up to -- just represent up to 70 percent of total financial mediation compared with 30 percent in the U.S.

As a consequence of the crisis, of course, we also have to look at the systemic risk, macroprudential instruments. And as a result, the ECB now is also involved in macroprudential policies mainly through the European Systemic Risk Board. In other countries, like the U.S., also this macroprudential overlay, that is this part of the financial stability which is added to macroprudential policies and crisis management and resolution, this element has also been introduced in the E.U. and in this respect we play a role in, for example, in calibrating the countercyclical capital buffers and also playing a role in coordinating other macroprudential instruments.

Turning to international cooperation, as you know, central banks reinforced, strengthened their cooperation. This cooperation has been strong or close over the years. It became stronger during the crisis, mainly through liquidity provisions using swap lines. Development related to the crisis is also greater attention paid by central banks, in particular in the context of the BIS to global liquidity conditions. That is one of the contributing factors to the crisis has being the liquidity created by the financial system or the private side of the liquidity. And of course, central banks have an interest in monitoring developments in this area because when for various reasons this liquidity -- there is an increase in risk aversion, this private liquidity tends to evaporate very quickly and then central banks have to step in to substitute for this private liquidity which is no longer available and to provide official liquidity.

So it’s a new area. There’s work going on at WBS together with the IMF and it’s certainly something that will develop in the period ahead. And also, there is currently work on developing best practices for the central banks to provide -- to put in place swaps. Currency swaps.

Let me turn finally to governance just to say that the central banks have been able to contribute to stabilizing or to mitigate the risk associated with the crisis. This was feasible because they were effective in discharging their responsibilities. And I think two elements were fundamental in this effective role. One was the clarity of the mandates, objectives, and tools before the crisis. Of course, there has been, it is well known, a lot of improvement in terms of governance of central banks before the crisis, and the other element was their independence or autonomy. And the two elements are linked because central banks can be independent or autonomous because they are expected to be held accountable in respect of the mandate that they are given.

So I think when looking at the crisis we have to keep in mind these two elements, in particular when it comes to the non-standard measures or the use of the balance sheet of the central banks to address some financial stress. And there are several difficulties arising from the use of the balance sheet of the central banks. One is that this use implies coordination with other agencies like supervisors in the case of banks or like debt management offices in the case of sovereign debt purchases. And this might impinge on the operational independence of the central bank.

Another aspect is the communication. That is communicating on these balance sheet policies is much more complicated than communicating on standard interest rate policy, both in terms of objective and in terms of tools and the effectiveness of tools.

And the third element is the fact that these, as a rule, these balance sheet policies are difficult to calibrate. That is you tend to use a very large amount of assets and this creates a financial risk for the balance sheet of the central bank and then might also undermine the financial independence.

So these considerations have to be kept in mind when looking at the use of these balance sheet policies and is the reason why they may be used as exceptional measures for a given period of time. They may be useful to buy time in order to give more room to maneuver for the other policy makers that need to -- who need to address the underlying issues as in the case of banks, recapitalization if the problem is not a liquidity problem but a solvency problem, or in the case of sovereignance when the issue of sustainability of the fiscal position is called into question by markets.

So I will stop here. Thank you very much.

MR. STEPHAN: Good afternoon, ladies and gentlemen. Doug, thank you very much for inviting me. Thank you for joining this event.

I would like to say more on the economic governance, which in my view is very central to the further developments. I appreciate the title of the event today because it's more focused on the medium longer term perspectives and doesn't focus too much on very short-term issues because I feel that markets and observers focus a lot on short-term issues, how to solve the current crisis, which of course is important but we tend to forget that some measures take very quickly to calm down markets very quickly might have some serious detrimental effects on the medium to longer term.

Let me explain this in more detail. I would like to start with the Maastricht Treaty. So the Maastricht Treaty basically builds on two pillars. The first pillar still standing basically is the institution framework for the ECB, an independent central bank with a very clear mandate for monetary policy. And the ECB was able to deliver according to the mandate and in this way was very successful. The difficulty much more is with the second pillar, which is also written down in the Maastricht Treaty but which was forgotten maybe as not so important. But it says that membership states shall regard the economic policies as a matter of common concern and shall coordinate within the council.

SPEAKER: Excuse me. Could you tilt the microphone closer to you?

MR. STEPHAN: Better?

So again, the second pillar is the pillar dealing with the fiscal policy coordination and the Maastricht Treaty says that the member states have to coordinate fiscal policies, economic policies and treat them as a matter of common concern. This unfortunately has not ensured adequate economic policy coordination within the euro area and has not prevented the emergence of serious excessive macroeconomic imbalances, has not ensured adequate fiscal policy coordination in the euro area.

So in some countries of the euro area we have some significant internal-external macroeconomic imbalances and manufacturers basically contributed to this. For instance, inflation rates above the average of the euro area, wage increases above productivity rates leading to unit labor cost increases. Then we had excessive credit growth and we had some real estate price bubbles. Also, finally, what was not so helpful was that financial markets or participants underestimated associated credit risks. So this led to current account deficits and to very high debt levels, which I should put into brackets that the debt problem is not only concentrated in Europe; it's also a problem for many other countries in the world.

So although we have this unsustainable development in some countries of the euro area, this does not mean that the fundamental logic of the treaty is not still valid. So still the governments have to focus on establishing sound fiscal and sustainable macroeconomic developments in their countries. Basically, the procedures and instruments have been available all the time but they were either not implemented or ignored. And also peer pressure did not work out so well. So although the Maastricht Treaty said the right basic principles, there was a lack of political will to follow up on the second pillar. So what we see is that we need to kind of change the mindset of all parties and that we need a new quality EMU economic governance. Also to stop the current crisis because the fiscal problems are at the root of the current crisis and if you don't solve these problems we will never stop the current debt crisis.

So next what I want to say is what is the way forward. So from our perspective there are basically two possible options for the future. One is to stick with the

Maastricht Treaty. To say, okay, fiscal competence still remains within the member states, that still the no bail out clause is reconfirmed, that we basically don't want to have expenditure decisions taken by individual countries but risks out of these expenditure decisions are taken care of by the other sound member states or by the European level. So the bailout clause still holds. We would need the financial market as a disciplinary instrument and it would need -- which would be important, much strengthening of the current frameworks or in our view what has been done so far is a big step forward but it it's not -- we are not yet there, that we have a strong framework which would ensure such good economic governance. So this would be the first option, which in our view could work out.

The second option would be to significantly go ahead with European integration. So this would require comprehensive changes in our national constitutions and in the EU treaty. This takes, of course, time. This could lead in the end to full fiscal integration and also basically to joint risk sharing at the EU area level. So, for instance also to euro bonds.

This, of course, would require the discretionary power on the national level and for governments and parliaments have to be cut back and decision-making would shift much more to the European level which does not necessarily mean that all decisions would have to be centralized, so decisions could be taken on the national level as long as you stay within some limits and run a solid budget and fiscal policies. But if one member state fails and does not deliver such a policy then it will lose the budget sovereignty and this would go to the European level.

So where we stand currently we have some decisions taken. So we can maybe talk later about it. We have a strengthening of the Stability and Growth Pact. We have more macro surveillance. We have more policy coordination. We improve the quality of statistics and so on and so forth. We have an EFSF as a vehicle providing liquidity assistance. But what the problem with this so far is from our view that we stick in a way to option one saying all decisions still remain with the national government but we move with these measures with some of these I described more to risk sharing and joint liability. So we see it would be much better to decide very quickly on which avenue we would like to follow up so let's go with the Maastricht Treaty, strengthen further the framework, or let's go to more European integrations. But let's decide so this in between mingling the two options is not helpful and might create risks and might also have an impact on the central bank independence and also on the separation between monetary and fiscal policy in a way.

So my point is we should have a very quick decision where we would like to go to and then go forward. And in both worlds I think one remains true. For policymakers you have only degrees of freedom in your policy decision-making when you are contingent and prudent and responsible behavior at home. So this I think we have to keep in mind and therefore we need a change in our mind, a change of behavior basically of economic policy. Thank you.

MR. ELLIOTT: Thank you. Don.

MR. KOHN: Thank you, Doug. And thanks for the opportunity to participate. It should be an interesting late afternoon.

As a former central banker I find I have a lot of sympathy with the ECB. I think the ECB has found itself in a very difficult place in a way that I see parallels with what was happening to the Federal Reserve, especially before TARP was passed.

It was the only really rapidly responding functioning institution in the euro area able to make and implement decisions very quickly. As a consequence, it was looked to and has been looked to for the kinds of actions that it wasn't used to making and that some people thought were sort of outside -- strictly outside very strict central banking as it had been understood and practiced and I think I feel a little Bear Stearns, AIG kind of sympathy with this looking to the only institution that has the money and is working rapidly.

I think the ECB has been concerned appropriately about being a covert fiscal redistribution mechanism. We just heard that, and I think appropriately, that Europe needs to make a decision how to handle fiscal policy, where the responsibilities will be, who will end up paying. And the ECB has been resisting taking risk on its balance sheet from just say a few countries or a few banks and then in effect having any loss it made absorbed by everyone in the euro area. It's feeling has been that acting in a fiscal way, mixing fiscal monetary policy would undermine its legitimacy and support and I think there's good reason to be concerned about that.

The ECB has been worried that people and their elected representatives haven't really, until very recently, understood the seriousness of the situation or the consequences of their words and actions. For example, the risk of contagion from private sector participation in Greek debt restructure. That may be entirely necessary but at the same time you're doing that you've got to handle the contagion. And it's only been recently I think that people have understood that.

As I said, I think the Federal Reserve as in a similar place through Lehman, AIG, Bear Stearns, but in our case Ben Bernanke could talk to Hank Paulson and say enough. WE think it's time to go to the Congress and get backing for this. And together with Hank Paulson go to the Congress and get TARP passed. Not that it was easy, but remember Bernanke and Paulson had one legislature to go to, not 17. So it's very complicated in the euro area.

I think one consequence of these concerns weighing on the ECB has been that it's walking a very narrow line here. It's trying to do enough to buy time to implement the fundamental change we've just been talking about but it also wants to keep pressure on the politicians to make that fundamental change that it needs to do. And therefore, its actions have sometimes appeared to be halfhearted, temporary. It's hard to take firm positions and then back off like we're not going to buy sovereign debt, we don't want the IMF involved, and then it backs off because it just has to keep the euro area stable.

So it's been subject to two kinds of criticisms. One that has gone too far and some of its German board members have felt that way and by others that it's done too little, many academics and market observers. I want to talk about three sub-issues here: market making for sovereigns, the so-called lender of last resort for sovereigns that a number of people have been talking about of late; monetary policy; and then ECB governance, the lender of last resort for sovereigns, making a market in sovereign debt. There are some out there advocating all-out support for sovereign debt calling it a lender of last resort function that is beyond Greece, and that view is based on two things. One is that it is the alignment of sovereign and central banks with one currency that distinguishes the U.S., the U.K., Japan from Europe where the -- I'm sorry, with the, yeah, where the sovereigns in Europe are issuing in what somebody called sort of a foreign currency. So they don't have control over their currency or their central bank. Greece doesn't. Italy doesn't. They're part of a larger thing.

And the thought is that in the case of the U.S., U.K., and Japan, markets know that the central bank will support the debt whatever the consequences and thereby the sovereign can't default. That's the reasoning behind this. I disagree with that but I'll come back to that in a second.

And I think a second piece of the reasoning behind why the ECB should be much more active in supporting sovereign debt is that these folk consider problems outside of Greece and a few peripheral countries as being liquidity problems, not solvency problems. In their view markets have been disrupted by panics and there's really no question of the willingness or the ability of these sovereigns, the peripheral sovereigns, to meet their obligations if it weren't for the panic induced high interest rates. So it's a liquidity problem, not a solvency problem.

So I disagree with the first proposition that the only problem is a lack of lender of last resort for the sovereign. I think it's much more complicated than that. None of the central banks that have been cited -- the U.S., the U.K., Japan -- see themselves as a lender of last resort to the sovereign. The purchases that these central banks have made are supporting the markets in their sovereign debt only because reducing interest rates are consistent with achieving macroeconomic objectives for inflation and output.

There is no sense that the Federal Reserve, the Bank of England, the Bank of Japan would support those markets, would be a lender of last resort if that was inconsistent with their macroeconomic objectives, that they would inflate away the debt if necessary. I think inflation is just another form of restructuring and repudiation. I don't see any sign that these other central banks -- U.S., U.K., Japan -- would be willing to do that. So I don't think the problem is the lack of a lender of last resort, someone who would be there no matter what. I think the problems in the euro area and in any currency area is the lack of an independent monetary policy and exchange rate adjustment by the various constituents of the euro area. They join together with a common monetary policy and they can't change exchange rates so they can't offset the fiscal austerity that they've been required to engage in order to get market -- restore market confidence. They can' restore their competitiveness by depreciating their currency. If they were able to restore competitiveness by running an easier monetary policy allowing the currency to depreciation, that would keep the tax base from shrinking so much.

So I think in the currency area there is a greater risk of default by individual sovereigns but it doesn't derive from the lack of a lender of last resort; it's a lack of independent monetary policy. That's what they signed on for.

I think the ECB apparently disagrees with the second proposition behind these advocates of more active ECB policy. That second proposition, remember, was that this is a liquidity problem, not a solvency problem. I think the ECB through its actions and its words apparently sees some risk of loss in the sovereign obligations. Think about the conditions for intervening. The letter to Berlusconi saying what Italy had to do in order to get intervention suggests to me they didn't think fiscal policy was on a sustainable track. They don't see buying sovereigns as a natural extension of Bagehot, the traditional central bank intervention as a lender of last resort because in those cases central banks are not supposed to take risk. Read Bagehot. You're supposed to lend against good collateral to solvent institutions and not put the balance sheet of the bank at risk.

I'm not in a position to judge whether the ECB is right or not about the sustainability of the fiscal positions of these countries but I do think it needs to recognize that it's sending a pretty strong signal to market participants when it doesn't think the country has aligned its fiscal policy to meet its obligations. I'm not sure why private market participants should think it has. Solvency and liquidity are related and the difference between the two is not very clear cut particularly in a crisis. Lack of liquidity contributes to solvency problems, questions about solvency contribute to liquidity problems, so intervening to boost liquidity could help solvency but I think we all need to recognize it's not a clear dividing line between liquidity and solvency.

I think at some point there needs to be a grand bargain between the ECB and these other countries. If the country does certain actions the ECB will support it in size because we do see if you take those actions risk as limited once growth is restored. The ECB could say the markets don't believe it but we do. Evidently we're not there yet but I think some approach by the ECB, some promise that if certain actions were taken their support would be more robust, would be helpful to offer a carrot to these countries and to help bring stability to the situation.

Monetary policy, as I noted, I think the real problem in a monetary union or the real challenge in a monetary union is a lack of adjustment mechanism to bring costs into line, restore competitiveness, reduce dependence on capital inflows. Now, I think the question here is, are the peripheral countries condemned to many years of recession to affect an internal depreciation since they can't have an external depreciation. I think this obviously is what is worrying their constituencies.

And I think the ECB can help here to relieve some of this pressure. I would say two things come to mind. One is I think a little bit more of a focus on growth still consistent with price stability. It's going to be really hard for these countries to adjust if the whole area is in recession. So I think keeping them out of recession, keeping the euro area out of recession, fighting recession is going to be extremely important to facilitating adjustment by the peripheral countries that are in trouble. And secondly, I think they need to make sure that their focus is on inflation for the whole euro area, not just for the core and certainly not just for Germany.

It would facilitate adjustment by Greece and the other troubled countries if Germany ran inflation a little bit above two percent. If you got the average inflation for the euro area with Germany running a little high so that Greece, Portugal, Ireland could run lower and start affecting the change in relative values, the change in relative costs that were needed without necessarily dipping deeply into deflation. I think if Germany ends up running a two percent inflation those other guys are going to have to be deflating and that could be very, very serious. So I wouldn't aim to have Germany above two percent but I think it's really important that the ECB keep its eye on the average inflation rate for the whole euro area and not just on one or two core countries.

A final word about internal governance, I think the ECB would benefit from a little more transparency about deliberations and from formal votes on policy issues like other central banks do. I think formal votes would allow people to dissent openly. I think the resignation of key members because they disagree with policy is not a good development. It's not confidence inducing. And they need to have ways of formally registering that they don't agree with the policy without having to resign.

And I think there needs to be minutes of the decision process without attribution. The public needs to see that all the views were discussed, how the decision was arrived at, that everything was considered and what ended up winning the day -- how the decision was made. And I think minutes of the deliberations would enhance confidence in the ultimate outcomes. Thank you.

MR. ELLIOTT: We're just going to get ourselves miked up here and then -- okay, excellent.

All right. As I mentioned, what I'm going to do is just ask a few questions of the panelists here for them to discuss and then after that we'll turn to the audience. So I will go through in the same order as we did the original presentation. So Georges, you're up.

So I was wondering, could you talk a little bit about the decision-making process within the ECB as Don was alluding to? And perhaps a little bit about what is the role of the president of the ECB and how might a change of personnel have some effect on how that group works?

MR. PINEAU: Yes. I think there was a reference to that recently in the conversations around the succession of Jean-Claude Trichet by Mario Draghi. I think President Trichet referred to the fact that Draghi had been onboard on the shape of the ECB and the Eurosystem since almost the beginning. And so it's not as if it was a new member but he had been part of the team for many years. So I think he tried to stress this notion that the governing council is a collegial body. The president is certainly playing an important role as building consensus. That is it's clear that the president plays a role first within the board of the ECB, the six members of the board because as a rule most important decisions either policy-related or even decisions in other areas that are not policy sensitive are put forward by the board as a body. That is there must be first a consensus within the board to go for a proposal to the council. This is varied for interest rates but it is also varied for other decisions like, for example, non-standard measures.

And then on the basis of this consensus within the board, then you have a discussion in the council and, of course, before the discussion in the council there is a lot of interaction among board members or the president and other members of the governing council. So before the meetings of the governing council you have already a pretty clear idea of what might be the consensus around the decision. So from this perspective the role is important but I think it's rather similar to the role of the chairman of the FOMC in the U.S. where you need to have deliberation, of course, in the FOMC but before the deliberations you certainly have a lot of interaction between members of the FOMC.

So the results, the outcome of this is that to the extent that you change one member in the governing council you could expect inertia that is probably the new president will be able to steer the governing council in the direction he might prefer. But, of course, he would have to take into account the positions of the other members. So it's an important role but at the same time this role is taking place within certain constraints.

MR. ELLIOTT: Okay. Let me ask you one other question which is if things were to go really seriously wrong in Europe, if you were to have say Italy lose access to the markets at reasonable price, what kind of tools does the ECB have available to help in resolving that situation?

MR. PINEAU: I think have to, yeah, you have to consider what happened for other countries in the euro area which lost market access. And in this context you would need to consider not only financial support or either in the form of liquidity provision to the banks which is already the case although if you look at the current recourse of Italian banks to the ECB, this recourse remains very, very low. So in terms also of what the SMP has been doing recently, the amounts are not that big because currently the outstanding amount of bond purchases under the SMP is 173 billion Euros.

So I think you would have to consider if you -- and it's a little bit the point which was raised by Don Kohn earlier on that is this -- when he mentioned the sort of ambivalent attitude of the ECB with respect to liquidity versus solvency problem. I think one issue there is, of course, the need to have objectives well aligned. That is it is possible probably for the ECB to take some measures provided there is full confidence that the policies that are under the control of member states, these policies are consistent with the objectives that both the ECB and the member states are trying to achieve. So from this perspective I don't think that the ECB alone would be in a position to have assistance can suddenly be provided but a broader framework would be needed in this case.

MR. ELLIOTT: Okay. Joerg, could you talk a little bit about -- you're at a central bank which is a national central bank within the Eurosystem. Could you talk a little bit about how the Bundesbank intersects with the decision-making process at the ECB level?

MR. STEPHAN: There are a lot of contributions we make as a national central bank within the Eurosystem. First, of course, our president is a member of the governing council so he is a part of the decision-making body and has to be prepared adequately, of course. And then what probably not everybody knows is we have a lot of really (inaudible) of committees underneath the governing council which prepare all the decisions and so this committee structure or every national central bank sends delegates into these committees and we work there with our colleagues to prepare decision-making and payment systems and bank note productions. So every central bank topic is discussed there so this is a full body and there we contribute. And, of course, we play an important role in implementation of monetary policies. The decisions are taken by the governing council but then the implementation of the measures are done by the National Central Bank, in particular by the Deutsch Bundesbank. So I think this has roughly said how we contribute.

MR. ELLIOTT: Okay. Let me ask you, Don, I think, had alluded to there being differences of opinion at times between the Bundesbank and the ECB. Could you talk a little bit about what kind of advice the Bundesbank is providing that might be a little different than what the ECB has chosen to do?

MR. STEPHAN: So our president, as I said, is a member of the governing council and so he makes his comments and contributions to the discussion in the governing council and I would not like to elaborate now in detail on that. But I think he made it reasonably very clear his opinion. But we, of course, if the decision is then taking, you know, we accept it and also we stay to it and we do defend it. So we need to contribute to the discussion. We might have from time to time different views but this is how it is. This is a governing council of many members and we will do so also in the future.

I mean, you might have heard what I had to say but what we think, it's basically the current problems are within the fiscal area basically and you know, this could be very quickly stopped if it would have a real decisive behavior change in fiscal policymaking. If one G7 country in the euro area in the south would, I mean, it's a very rich country. The net is per income is much higher than in Germany, you know, so this is the tax base you have so you always talk about debts, you know. Debt is one side of the story but you also have assets. You also have assets. You can tax assets. There are some wealthy countries so you cannot tell me that they cannot handle their own fiscal policy.

I think if you convincingly implement a policy -- sorry, and then the markets would recognize it and then it would come down I'm pretty sure of it. So currently we should not coordinate and visit, plan. We should implement, implement, implement. If you do that I'm really convinced it will be really very quickly the crisis behind us and the ECB as a bridging kind of -- bridging the situation would no longer be needed. So that's my view.

MR. ELLIOTT: Okay. Thank you.

Don, you have the benefit of having been a central banker yourself. Could you talk a little bit about -- you've touched on it a bit but what you see as the principle differences between the Fed and the ECB in terms of the decision-making processes?

MR. KOHN: I think the fundamental processes are actually very similar. I mean, you're trying to accomplish approximately the same things. You're trying to establish macroeconomic stability. The ECB emphasizes price stability. The Federal Reserve talks about a dual mandate. But I think most people would look at what the Federal Reserve did from about 1979 on and say that it wasn't all that different from somebody from a central bank that was emphasizing price stability at least as much as employment. In the end I don't think there's that much difference in the monetary policy make and the process isn't that different in the sense that the Federal Reserve has reserve banks that have independent research capability, have independent views and they come in to discuss monetary policy with the board of governors. So I think there are more similarities than there are differences. I think I tried to stress a little bit the difficulty. I think the difficulty the ECB has in the sense that it is in reporting the 17 different finance ministers in some sense and there is a problem of coordination there, I think another problem in the euro area as compared to the United States as a currency union is there's a lot more labor mobility in the United States and a lot more fiscal redistribution in the United States naturally through the central government.

So whereas I was trying to emphasize I think the underlying problem in the euro area is partly fiscal but I think there's even more fundamental issues in some countries. I'm not sure about the one you were talking about but some others of the lack of competitiveness and even if their fiscal policies were in balance, if they have a current account deficit the private sector has got to be borrowing money from somebody and somebody has got to lend to them. In the United States, of course, that happens among the states but there is a more natural fiscal redistribution through the central government than there is in the euro area and I think there's more labor mobility than there is in the euro area that acts as a bit of an equilibrating mechanism that isn't there in the euro area for these differences in competitiveness.

We still have areas in the United States that have been poorer than other areas over long periods of time, just as there are areas within Italy or other countries that have been poorer for long periods of time. So it's not a perfect equilibrating mechanism but it's more than is there between sovereigns within the European area. It's easier to make policy for the whole area for the whole United States than for the whole Europe I think.

MR. ELLIOTT: Okay. And you may not want to answer this one but is there any advice you'd care to offer the ECB in terms of the current sovereign debt crisis?

MR. KOHN: I think I went about as far as I want to go in my remarks. So, right. As I said, I think the ECB is in a very tough situation. And I can sympathize with how they're torn. I do think that these -- trying to walk that narrow path of keeping pressure on, so you don't want to do too much to solve the problem because then the politicians won't. And holding the area together gives the appearance of a sort of stop-start, temporary, half-hearted, don't really believe it kind of thing. And at some point I think they're going to have to kick in a little more vigorously to keep it a little bit like the point you were raising before, Doug, to keep the thing from sort of spinning out of control at some point.

MR. ELLIOTT: Okay, thank you.

Why don't we take some questions from the audience. I think what we'll do is we'll take three at a time. So, the fellow back there.

SPEAKER: Yes. So a comment and a question.

The comment is surely it is true that if the U.S. Government or the U.K. Government or the Japanese Government was in a terrible bind that they could rely today on the central bank to support their bonds. And I understand the central bank, as a former central banker you don't want to say that but I think the markets believe correctly that that is what would happen. So that's my comment.

My question to the panel is can you take us through what is wrong with the proposed solution by many or by some astute observers with the solution that the

European Central Bank should simply say I guarantee the purchase of government bonds of our constituent nations? Could you take us through what is actually bad about that solution? Some people believe that that would solve the crisis overnight.

MR. ELLIOTT: Okay. Like I said, let's take two more and thanks for reminding me, Uri. Please, as he did, give us your name and your affiliation when you do that. And let's avoid the comments if we can and just get the questions.

The woman here.

MS. JOHNSON: Karen Johnson, Consulting Economist. I had a comment but I'll skip it.

Question. As long as the present fiscal setup has national sovereign debt and the ECB is put on the spot in terms of making decisions about what it will buy and what it will accept as collateral and whether it will accept everything on the same terms, like par, say, or whether it will begin to pick and choose among the sovereigns. And that puts it right in the middle of this crisis in a way that wasn't explicitly touched on yet. There has been this other idea of creating a euro bond and achieving a kind of European fiscal integration, not complete, not on the tax systems or on the spending decisions, just on the borrowing, that there would be a mechanism that would govern borrowing and deficits and the bonds, at least some portion of the bonds, would become Europe bonds. And I would just wonder if any of the panelists might comment on how that would alleviate the pressures on the ECB.

MR. ELLIOTT: Okay. And the fellow in the blue shirt. You were looking to ask a question earlier? Yeah. Okay. It was already asked. Then the woman up here.

MS. GRIESGRABER: Thanks. Jo Marie Griesgraber, New Rules for Global Finance.

In terms of the exchange rate it looks to me, and I guess this could be formed as a question, it seems to me that Germany is benefitting in terms of its surplus.

The trade surplus indicates it's benefitting from the pressure on the Euro from what we're calling the peripheral states, sort of the not-as-important members if I might imply that.

And also, how is it that the peripheral countries are ever going to be able to contribute if the conditions on them really do push them into a recession? I'd just like to, you know, push that button a little more.

MR. ELLIOTT: Okay. So why don't we do the same. Georges, any comments you'd care to make to any of the questions? Any oral?

MR. PINEAU: Yeah, I think on the question raised by Uri on the guarantee, of course it relates to the issue of liquidity versus solvency. And to the contagion that is it's probably clear that initially the issue was confined to Greece and we've seen some contagion to other countries that were in different situations. But it is -- developments that we have seen since last year have shown that there is clearly a need not in all countries but in some countries to do something in order to adjust policies in order to convince markets that the fiscal positions are sustainable.

Again, initial conditions vary from country to country. You can't compare Spain with Italy. But I think the overall situation is that given market pressure it is difficult to argue that by just providing liquidity or by extending a guarantee that you would address the issue because at the same time you need also to adjust policies to make sure that the fundamentals are as good as would be assumed if you were to extend such guarantees. So we're back to this issue which was already referred to by Don Kohn. So I think what has been done until now is to stabilize the situation and to do that you need both elements -- that is adjustment but also some support.

On the issue raised by Karen, I think it's something which will probably be introduced at some stage. That is some form -- the different schemes that have been put forward, for example, debt management agency or collateralized bond or the blue bond. But I think most EU member states would consider the first step would be to have much closer fiscal coordination; that is the ability of member states to interfere with the fiscal policies of other members. And once you have a more solid, more robust fiscal coordination, then probably you can have this step of managing together the sovereign debt. But the issue there is the issue of time. That is how long it might take in order to get that given market pressure. But I think it's difficult to, again, to go for this solution without having first shown that you are able to define rules that are really complied with in terms of fiscal management.

MR. ELLIOTT: Joerg?

MR. STEPHAN: I think the guaranty -- the question on the guaranties and on the euro bonds are similar in a way. So what they would do is they would distort incentives for good behavior. So we are still in a world where the countries are responsible for their own fiscal policies, expenditures, so they decide what has and whether they support schools or build roads, whatever. So they decide on their expenditures.

But if you would have such a mechanism on your area level it would mean that whatever this has as a consequence or unsustainable increase in debt, for instance, would have been born, I mean, would have been compensated by other stronger member states. And this would not have -- so the incentive would not be there to change behavior, to follow prudent policies. So for instance, if you would compare it with the U.S., for instance, you would have to imagine, let's assume on the federal level there are almost no expenditures because in the euro areas or the euro area level it's almost, let's say, not that important for expenditures so that's the single member states.

So in the U.S. you would have to assume all states basically make the expenditures and are responsible for their own expenditures only. And they would decide how to, I mean, whether to have free access to universities, have low pension age. Let's assume state C decides to have free universities, very low pension aid, and stuff like that, and then State V is very prudent and has appropriate policies. State C runs into problems because the expenditures run away. Then they say, okay, I have some problems. Debt increased so much and what can I do? Please help me. So State C would have to say, okay, I put some money on the table. I guarantee your bonds. State C issues still bonds, you know, and then States V ensures this or contributes to a bond. And State C would not have any incentive to change anything. So that's basically the issue is about incentives.

So if you would have in the end full integration and fully integrated fiscal policy which means democratic legitimated decisions on a European level on fiscal policy, then you could have these measures I tried to elaborate in my first statement. So then this would be the way to do it but not what I said. Mix these two options, how to stay still with the current framework but add some elements which would come into play only when you have more integration. Then, if you mix this up then you have huge incentive problems.

With regard to the exchange rate question, I would say the current strengths from the Germany economy stands from reforms made under Chancellor Schröder, which really changed labor market flexibility very much, improved labor market flexibility, and also wage negotiations much more on the regional company level which really contributed to the good performance of the German economy in the current crisis. And also it stems from very solid small-medium sized enterprises which operate under full competition in the world economy. And of course Germany benefits from the euro area and we would like to have this also in the future because we have been protected, you know. If it would have been in a different world where we would have had the Deutsche Mark, for instance, we would have had a huge appreciation. And this would be, of course, an issue.

So we benefit but all the other member states benefit as well because of the common monetary policy. So I wouldn't say Germany is the only country benefitting from it.

MR. ELLIOTT: Don?

MR. KOHN: I think building a little bit, I was trying to think of a U.S. example of the center being responsible for the bonds of the periphery. I can think of two examples -- Washington, D.C., and New York City. And in both cases those entities lost their sovereignty to decide their own budgets. Right? So Alice Rivlin, Brookings scholar, ran the budget of Washington, D.C., while it was dependent on the U.S. Government and Felix Wright or whatever ran the budget of New York City. So I think if you're going to come in for help to the center you're going to lose a lot of sovereignty. And there has to be tough conditions on it in order to do that.

And I would say that's true for guaranteeing. If the ECB were to guarantee these bonds it would be putting the help of the rest of the euro area behind the peripheral countries or the countries having trouble and there has to be some mechanism in there to discipline those countries and it shouldn't be the ECB per se. It should be decided in a much more democratically accountable way I think than the ECB. I agree if the ECB were to do it, it probably would be successful, at least for a while until things -- until the discipline broke down and then it wouldn't be successful.

I wonder whether, as to your first comment, if I can comment on Uri's first comment, whether the low interest rates on U.S., U.K., Japanese bonds really reflects the expectation that even if it were inconsistent with holding inflation low these central banks would come in and support those markets. Because if were inconsistent with holding inflation low then there would be an inflation premium built into those bonds. And certainly there have been countries in which central banks did that, supported the government and ended up, in effect, defaulting or restricting the bonds through the inflation tax. So I don't think -- I don't think that's why interest rates are low in these three countries and high in those other countries. There is something to having a central bank as a lender of last resort than the country but I do think it's a much more complex thing than just dependent on that.

MR. ELLIOTT: Okay. Let's take some more questions. Teresa.

MS. TER-MINASSIAN: Teresa Ter-Minassian, from the IMF. I have two questions. One is Pineau.

Basically, what you seem to say is that what the ECB should do in order to provide more support is to have conditionality. So what I'm saying is, are you advocating for the ECB to turn into another IMF for Europe?

And the other question is for the gentleman, for the Bundesbank representative. What do you think of the Bruegel proposal of guaranteeing debt up to a certain limit, let's say to the Maastricht limit, that there would be -- I'm sure you're familiar with the proposal. Thanks.

MR. ELLIOTT: Okay. Other questions? Yeah, over there.

SPEAKER: Peter Boget from the German Institute of Global and Area Studies.

Is there any other way when the fiscal problem is obviously number one but the currency is really the major one at the end of the day? And is there any other way than just deflating in those inflationary countries and inflating in Germany and (inaudible)? And if that's the case, that is a change of mind I do not see forthcoming fast but maybe we have better ideas.

MR. ELLIOTT: Okay. Any -- is there a last question? Yeah, there in the back.

MR. PRIVITERA: My question is also for -- Alex Privitera from German TV N24.

My question is also for the German representative because you focus so much on fiscal discipline but it seems that everybody has now recognized that the problem is a fiscal discipline problem but also a growth problem and that's what the pressure has been particularly on the Berlusconi government to achieve, not just to tighten the belt but also to have some kind of measures and implementing those measures that could have a positive impact on growth in a country that you describe as very rich but has been mired now for more than 10 years. Slow growth and a lack of competitiveness and, you know, and some of the sectors of the Italian economy particularly have broken away because particularly in the textile sector because that has been completely overtaken by other countries especially in the emerging economies.

MR. ELLIOTT: Okay, Georges, we'll start with you.

MR. PINEAU: Yeah. On this issue of the ECB becoming an IMF, no, I think the ECB got involved in this crisis management first through the liquidity provision to banking systems. If you look at Greece, for example, and the reliance of the Greek banking system upon the ECB has been very large over the last year and then through the SMP since May last year. But the first function is clearly within the mandate of the central bank, its contribution to broader financial stability. The second one is more borderline as already discussed. But the second one was seen as a bridge towards funding coming from the member states and the IMF. And when it comes to the IMF, initially there was some discussion whether this funding -- real funding, not bridge funding -- coming from the member states should be -- the support should come only from member states or whether the IMF should be involved. In the end it was decided to involve the IMF, so we have joint programs. And as soon as this joint program, for example, for Greece, Portugal and the Ireland were in place, in fact, the main contribution of the ECB in the context of this program has been to continue providing liquidity support to the banking system which in the case of Ireland, for example, has been very important; much less in the case of Portugal.

So again, you have to look at that from the perspective of this bridging operation, just to wait to try to stabilize markets in the period during which member states plus the IMF had to provide financial support combined with policy adjustment.

MR. ELLIOTT: Okay. Joerg?

MR. STEPHAN: So the Bruegel proposal is not so much different from the instruments we talked before about because even as you say up to a certain threshold you only issue these bonds, then above this again you have the same incentive problems. It's more, I mean, you limit this a little bit but still you have the problem there. From a certain point onwards you have the same problems. As regards possibilities to strengthen the growth rate, I think, okay, I refer too much to the fiscal policy maybe. Of course, you have to think about structural policies as well and some of those measures must not have, I mean, so, I mean, so huge consequences. On the budget, for instance, if you make your product and labor markets more flexible, then I mean, this must not cost anything. So it's more also the other political will to go forward and to strengthen growth. This means -- this I think also refers to one question on a particular country although I didn't mention the name of this one but I think, yeah, I think probably I'm confident that those countries, they have to recognize that this has to change and there are a lot of options for the policymakers. For instance, I mean, the pension age is 65 years. This has been fixed in Germany by Bismarck which was a long time ago and so life expectancy increased a lot in the meantime. And if you believe that we can still stick with the same pension age, I mean, I don't know whether this is the right way.

So I think two years or so to add should be manageable probably. So, I mean, we still face huge aging problems and we have to -- also Germany, I mean, it is not so that we don't have any challenges. Of course, I mean, our debt ratio increased during the crisis by 20 percentage points, you know, because we had these banks and we had to use some funds to recapitalize. So this is, again, it's a backdrop of aging against a backdrop of shutting down nuclear plants, all that. It's not that we can have a rest. You know, we have also to do more and to implement more structure reforms. I think this is very key. So maybe I was too much focused on fiscal but this is also a very important area.

MR. ELLIOTT: Okay. Actually, let me give each of you two minutes for any final comments you want to make, if any. Don, I'll start with you.

MR. KOHN: No, I don't think I have any final comments. I've said what I need to say.

MR. ELLIOTT: Don really hasn't adjusted to being a think tanker yet but give him time. He'll always be able to fill the time.

Okay, Joerg.

MR. STEPHAN: This was very good. So yeah, again, I think the crucial point is -- and also not only in Europe, it's also in other countries at stake. Debt increased very much in the last decades I must say and increased much more than assets or so. And this cannot go -- we cannot move ahead in such a way. We have to rethink it and we have to -- even as I mentioned aging, it's not only a problem for Germany. In some countries it's a little bit delayed but it will still be a problem in a few years and health care systems and all that, we have to do more and I hope that the crisis might be helpful, you know, to put more pressure early on politics and that we might maybe benefit in the end from this and that we have a change in mindset which might have come years later when we would not have this crisis. So crisis, the Greek word is always also a challenge. So.

MR. ELLIOTT: Okay. Georges, any last thing you'd like to say?

MR. PINEAU: Yeah, no, just mainly on the fact that, of course, the problems we're facing now are quite acute, you can put them in the broader context of some ramifications of the crisis because some of the issues we're facing are also faced currently by other central banks as I tried to show in my presentation.

The fact that the ECB, as Don Kohn referred to, was operational rather effective and that the balance sheet was available probably initially was useful in stabilizing the situation or developments in the euro area. Now I think we are at the ECB hopeful that the member states and certainly at the core of the euro area realize that they need to step in. That is, this bridge that has been provided by the ECB cannot be extended for too long because I think it would be problematic both for the ECB in terms of effectiveness and legitimacy but also for addressing the real issue.

The fact that the area, the heads of government have been very active over the last month not always seen by the public as being very effective but at least I think they have become aware of the depth of the problem and I think they are probably ready to assume a larger share of the burden. And I think clearly as Joerg mentioned you need to have meaningful progress in terms of governance among the member states not only in terms of fiscal adjustment but on certain terms of policies conducive to growth.

MR. ELLIOTT: Okay. Thank you. Thank you, everyone. And let us thank Georges, Joerg, and Don.

(Applause)

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