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P R O C E E D I N G S

MR. LOMBARDI: Hello to everybody. I want to just say a warm welcome to all of you for joining this event co-hosted by the Brookings Institution and the IMF on the latest WEO update that has just been released. As an IMF scholar, I regard this release as quite informative in itself, perhaps even more informative than the Fed's interest rate cut the other day. The last time I think the Fund issued a release was after September 11, although I have just heard that the IMF does plan to issue these updates more regularly in the future. In just a few moments I will be introducing the IMF's chief economist, Professor Johnson, who will share with us the IMF's appraisal of the current outlook dominated by the financial crisis that is unfolding for the first time in the context of massive international capital flows, unprecedented global imbalances, and especially the growing role of emerging economies in the global economy. How the interaction of these factors will play out is quite uncertain at this stage and I think this may well be a subject of the discussions later.

Without further ado, let me introduce today's panelists, Simon Johnson, Economic Counselor and Head of the Research Department at the IMF, as well as Ronald Kurtz, Professor at Entrepreneurship at MIT, Martin Baily, Senior Fellow here at Brookings, and of course, former Chairman of the Council of Economic Advisors under the Clinton Administration who will serve as the discussant to the panel, and Homi Kharas who will moderate the debate. He is also a Senior Fellow here at Brookings and the former Chief Economist for the East Asia and Pacific Region at the World Bank. I will now give the floor to Simon for his remarks. Thank you very much.

MR. JOHNSON: Thank you very much for the introduction. I think my mandate is to speak for about 20 minutes, leaving us lots of time for Martin's comments and hopefully discussion.

What I am going to tell you about is, if you like, the details or the thinking behind the numbers, the new forecast that we released on Tuesday. So the headlines are out there but we have not actually made this presentation in public before. We had a headline number, a global growth number, that we put together. You take all the growth rates of the world and you combine it with the PPP weights which we get from the world bank and which changed quite a lot in December, so all the numbers here to be very clear are using the PPP weights. We have gone back and recalculated so you can make that adjustment.

What we said on Tuesday is we expect growth at the global level, the way that we measure it, in 2008 to come in at 4.1 percent and that is down from 4.9 percent which is our estimated actual for 2007, so that is quite a marked slowdown. Our forecast back in October, our baseline forecast for 2008, was 4.4 percent calculated on the same basis.

So the forecast was revised down from 4.4 to 4.1, if you like, as the headline.

The key issue which I will come back to again is, and I would be happy to spend a lot of time on this in the questions, what is going to happen in emerging markets. I think we are well aware of the disturbance that has been concentrated in the United States and we have learned that unfortunately it has spread more than one might have initially expected to other industrial countries particularly in Western Europe, and I will talk about that in a moment. But how much of it is going to spread to emerging markets and in what form? That I think is absolutely a key question. We will give you a current reading of that, and it is something obviously that the IMF I think is uniquely positioned with 185 member countries, pretty much every country in the world, to have some insight on this. It is hard. It is a hard call. There are not the good, high-frequency data for many of the key economies as you have for the industrial world, but we will tell you what our current thinking is.

But first a little bit more on the U.S. and on industrial countries. Actually, and I did highlight this on Tuesday, our headline number for global growth and for the U.S., the U.S.'s headline number for 2008 is 1.5 percent, but that is an annual average number. That is actually misleading in a situation like this where you had a strong third quarter in 2007 and so that bumps up the annual average for 2008, and we can go through the details of that if you are interested.

A better way to see our view of the dynamic during 2008 is to look at the fourth quarter over fourth-quarter numbers. I will actually show you our quarterly forecast quarter by quarter for the U.S., those numbers obviously are very hard to get precise, but Q4 over Q4 I think shows you what we think is going on. Here you see a slowdown in the U.S. from around about 2-1/2 to 2.6 percent in 2007, to 0.8 percent in 2008. There is also a slowdown in the Euro Area, and that will come down in our view from about 2.3 on this Q4 on Q4 basis to 1.3. Japan has some very particular things going on in residential construction and let me put that to one side. The Japanese economy is not doing particularly well, has its difficulties, and the government I think is coming out with some new forecasts of its own quite soon. Do not look to Japan to save the world economy's very strong demand at this moment and we will focus more on the U.S. and the Euro Area.

There is some good news and I think it is important, particularly because sometimes people have been quite negative recently about the global economy, to remember the context and to remember some of the positives. First of all, the first context of course is we have had very strong global growth for 5 years and depending on what your view of potential growth is at the global level, you may now feel that at the global level we are not that far below potential. I am not sure, but we could talk about that. But that is a longer-term picture. It is a slowdown after a very long sustained boom by any standards.

Secondly, we are seeing, since the summer when we obviously had financial turbulence of a particular kind and we will go through that a bit more in the moment, some of the kinds of if you like automatic stabilizers that you would expect to function in mature market economies. Some of these are working perhaps a little bit contrary to some perceptions. For example, long-term interest rates are down, these are 10-year government bonds in the U.S., U.K., and Euro Area. You see that there is more of a fall in the U.S., but they are coming down everywhere. If you look at the right-hand panel here at U.S. interest rates, and these are interest rates and not spreads, usually you see this kind of figure with the spreads. You are obviously interested in the risk-free rate and the spread, so this is putting the two together. You see what has happened is obviously there has been an increase. Some of these rates have come down first of all since the summer, conforming mortgages have come down, and the interest rates on high-grade or investment-grade corporate securities have come down, jumbo mortgages have not come down as much depending on exactly what you measure them against, and of course the low-investment-grade corporates have actually gone up. So there is more a sort of differentiation of risk, if you like, within these markets and that is a pretty normal and encouraging sign.

There are however some much more worrying signs, and these we have been talking about for quite a long time. I do think sometimes that the distinction between liquidity and solvency is a bit overdrawn in this context because when banks have problems with their liquidity, it very quickly morphs into a solvency issue. But you can break it out to some extent, looking on the left-hand panel here, at interbank markets. This shows you the so-called TED spread and its equivalent in other countries, 3-month Libor minus the Treasury bill rate. This has turned out to be a very good and a rather unusual indicator of pressures in the short-term funding markets which are obviously of critical importance for the banking system. You do see that since the Fed and the ECB and the Swiss National Bank launched their special so-called TAF auction in mid-December, that spread has come down, and we do think that actually over the past 6 months all of the leading central banks have done a very good job of providing liquidity through various mechanisms under unusual circumstances while at the same time signaling that their monetary policy frameworks have not changed. So in some ways that has been a success. At the moment I would say that our view is these liquidity pressures have receded.

However, if you look at the right-hand panel you see something that is really quite worrying which is the credit default swap spreads on banks, and I am just showing you here the U.S. and Europe, the data for Asia are a little more patchy but they are headed in the wrong direction, and you see here that even since the TAF auction in mid-December that CDS spreads have gone up. They did peak at worrying levels back in November, then they went down, and now they are going back up again. So this is the market's view of insolvency risk and how much you have to pay to insure yourself against that risk. This is the 10-year CDS spread, with a similar picture if you look at other maturities. So there are definitely credit issues and issues with the market's fear of solvency of parts of the banking system.

You can also see this in equity prices. Of course, equity prices have to be interpreted with care. This may be telling you just the business models that these banks have of becoming less profitable, it does not necessarily mean that there is a higher risk of default. One reason I want to show you equities, I can actually add this data for more countries, you can see Korea, Australia, Japan with a similar sort of pattern and I can break out a little bit more within the European countries who have a lot of data, and you see that everybody again is headed in pretty much the same direction. It is true that this is a shock that began in and remains focused in and centered on the United States, but it is also true that other leading industrial countries including the Western European countries listed here have got pulled in to this because they were exposed to securities based on U.S. subprime and other mortgage assets.

The high-frequency data which we are getting on the U.S. are a little bit mixed. There were some good numbers for consumer durables, fourth-quarter GDP was not good, and we also all looking very closely obviously at the employment numbers. The housing-related employment has held up surprisingly well in the past 6 months, but we will have to see what is going to happen going forward. It is a complicated and difficult to read situation.

On the right-hand panel is something else that is difficult to read or something else that is a key issue that we have to follow, and it is complicated, is looking at one measure of future house prices in the U.S. Obviously there are very different views out there about how much U.S. prices are going to fall. This is using data from a relatively new index from the derivative market, RPX 25 Metropolitan Statistical Areas Composite. It shows you the forward term structure, and the way to read this is in cumulative terms so that this market is actually telling you to look at the dotted line which was January 18, the market is expecting a 20-percent fall in house prices measured in this way over the next 2 year, and then they think that it is going to be flat out to 2012. I do not know if that is correct. You can see certainly how the view has been revised down since

September, so there is a lot of updating going on here. One thing we have done is to look at various scenarios compared to our WEO projections. I did not get a chance to update these slides since the fourth quarter 2007 numbers came out so that the yellow line has shifted down a little bit for the near term although we think some of that is going to come back a little bit in 2008. We are pretty much sticking to our view of Q4 and Q4 2008 right now.

You can see that we are seeing this slowdown and then something of a revival as you go into the third and fourth quarters for the U.S. This includes the fiscal stimulus package which probably adds .2 to .3 to the Q4 and Q4 number in 2008. I understand that the package has not yet passed, but this is based on the indications we had of the size of it and the way that it is going to be made available. The downside scenario looks at what if house prices do fall. There is a small house price fall, about a 10-percent fall, built into our baseline. We can talk about the different price indices for that if you want. The downside scenario has a bigger fall in equity prices since the beginning of this year, and that of course turned out to be not such an unreasonable idea. There is a very big band though as you get out into 2009 and I would actually emphasize that this wide band is coming from the various assumptions that you make actually not about house prices, but about contamination effects. So you could have a big fall in house prices and if it stays concentrated in housing you could actually get quite close to our yellow line. If it spreads to credit cards, auto loans, if there is a big tightening of credit to the consumer sector more generally, then I think you start to go down to the blue line or even down below the blue. So I think that that is, if you like, the financial decelerator that everyone is worried about and rightly worried about, that there is some sort of downward spiral, and you can think of various stories through which this could occur. That is the U.S. scenario.

This is looking globally using a model that we have at the IMF and looking at what is going to have consumption GDP and of course current accounts as we are very interested in current accounts. There is a view, a view I must say held by some Europeans, that it is good to have a recession in the U.S. and this will somehow address global imbalances, the fact that the U.S. has been running this big current account deficit and there are these other big surpluses elsewhere in the world. Obviously this is just a simulation and just one way to look at this, but I think that kind of position is kind of having salutary effects and is going to help up global imbalances is actually not right, that it is not what you see when you do the reasonable analysis. You could have some small improvement in the U.S. current account, but remember that you have to build in what is happening in other parts of the world. The Euro Area could move into a small current account deficit, but we think the current account surpluses in this more severe adjustment scenario of slower medium-term U.S. growth remain pretty marked actually so that this is not taking care of the global imbalances by itself in our view.

In terms of where the risks are in other parts of the industrial world, we can talk a lot more about that. One thing to do is to put up house prices or other measures of asset prices across different countries and hide the names. When I do my dynamic versions presentation I leave the names off here and ask people to guess which one of the U.S. The U.S. does not actually look that bad in terms of house price increases over the past 10 years or in terms of various valuation rations. This is change in valuation rations and the same thing is true roughly speaking of levels. There are countries in the European Union for example that have had bigger run-ups in house prices. We will see what happens there if that is sustainable. This is showing you again the Europe-U.S. comparison. The U.S. and Europe have both had an increase in investment-grade spreads, these are CDS spreads, credit default swap spreads, and you see below investment grade is the same story, Europe has always been a bit higher than the U.S., but they have had a big jump up this year actually in those perceived risks.

I would emphasize that I think this is something that really needs to be kept in mind, that inflation has not disappeared. In the latest data from 2007 there is quite a lot of inflation around the world including headline in the U.S. but also core in the U.S. ticked up, and there are serious inflation worries in the Euro Area. I think the so-called second round effects are a very serious concern within the Euro Area and this is absolutely constraining what central banks can do and what they should do in this situation and I think that is true outside the U.S. In the U.S., we agree with the view that the economy is weakening significantly and we think inflation is going to come down in that situation partly of course because the U.S. does not traditionally have strong second round effects, but inflation is an issue. Even though inflation expectations remain relatively well anchored, and that is true across leading industrial countries, so the potential for inflation to jump up and then for monetary policy to have to tighten more down the road in order to get inflation expectations back under control is a very real issue.

And it is a very real issue for emerging markets. I think emerging markets in some ways are in a more comfortable position because they are coming off very strong momentum, and we will look at that in a moment. They are also though quite vulnerable. This is a simulated effect of oil price increases and oil and food price increases. Some of these price increases are buffered in emerging markets through various mechanisms. It does not always show up right away in the headline, but this is showing you what happens when they usually buffer it temporarily. So if you have a sustained increase in these prices, it does get passed on to final consumers eventually. This shows you how much happens in these emerging markets relative to the industrial world from oil prices and oil and food. Notice that food price increases are very big sources of shocks to emerging markets and that is absolutely something we have been stressing. There is a whole dimension of switching to biofuels that is further complicating the inflation picture more in emerging markets I would say actually. U.S. biofuels policy has a significant and unfortunate effect on inflation, headline and core, which is something that we talked about in our October World Economic Outlook, and I can go into that more if you are interested.

These emerging markets economies are running pretty strong. There is a fair amount of inflationary pressure there. I will come back to that in a minute. At the same time, they continue to attract large capital flows. The data on this at high frequency are not so good, but certainly if you look at the spreads for example on the foreign debt or on local currency issues you see a similar picture, no indication that flows in general to emerging markets have backed off. There has been some nervousness around particular countries, there are obviously we think serious issues of vulnerability that we have talked about in public that have to be addressed and we think that pattern of vulnerability remains to what we said in the October World Economic Outlook so that relying a lot on bank flows creates vulnerability. Again, if you look at asset prices and hide the names of the countries, you might not pick out where these countries are relative to the U.S. Look at the run-up in stock market indices for emerging markets. The asset price mechanisms do not work quite like in industrial countries, but this is an indication that there are more general issues there. At the same time, I would stress in this overall inflationary picture and inflation as a constraint, the oil market remains very tight and this is part and parcel of emerging markets staying strong. That is in some ways the good news, that is what is keeping the global economy going, it is also keeping oil prices around $90 a barrel. In terms of usable spare capacity in OPEC, our assessment, and I think we share this with the IEA, is there is very little out there. There is some sour crude in Saudi Arabia, but that is about it, and that is not really what OECD countries are looking for at the margin. So this oil market is tight and there is definitely vulnerability to supply shocks or fears of supply shocks which would then cause the second round effects that I have been talking about. High oil prices are one factor that is complicating the narrowing of global imbalances, and we can come back to that if you are interested.

In addition or perhaps centrally, we continue to stress that while there have been some exchange rate adjustments in what we would regard as the right direction since the summer so that the U.S. dollar for example has depreciated significantly in real terms, depreciated more than 20 percent in real terms since 2002, and it has come down by around about 4 percent if you look at the real exchange rate line, the real effect of exchange rates, that is the red in the left-hand panel, so that is a good thing. We think that is helpful for addressing global imbalances. And that has also been the case for some other places that the exchange rate in a sense moving in the right direction toward what we would regard as the medium-term equilibrium value that would get your current account down to its sustainable level either deficit or surplus depending on the country.

But if you look at other countries you can see pretty clearly that either the real effect of exchange rate has not moved in the right direction, moved in the direction that would bring the current account toward balance, or it has moved very little in that direction. We think that while we are encouraged by the fact that there has been a lot of exchange rate movement and it has not been disorderly, it has not led to an increase in long-term interest rates to go back to one of my early slides and that is good. At the same time it looks like the burden of adjustment and the burden of movement of exchange rates has fallen disproportionately on countries with floating exchange rates some of which of course are industrial countries, some of which are emerging markets but with floating exchange rates. Many countries that have various forms of fixed exchange rates have not moved much or have not moved in the right direction, and this is unfortunate. To be honest, we must not lose sight of the big picture. The big medium-term picture is one in which there is a lot of savings in some parts of the world, more than the countries want to invest, that is true in many oil producing countries, for example, in the Middle East, and it is true in China, it is true in Japan and some other parts of Asia. They have a lot of savings and those savings are looking for a home, and the mechanisms through those savings are being redistributed and come into the U.S. with the current account and the financial investment, that has unfortunately turned out to be associated with financial fragility and it is a financial fragility that we are trying to resolve and live through right now.

I do not think it is a good idea to just have a recession and not do anything about the fundamental imbalances. I think the fundamental imbalances while we are dealing with a slowdown in the U.S., I do not think I am seeing anything else, I think we absolutely should remain focused on the fact that this is a global issue, it is a global issue of imbalances in current accounts and in savings and investment. That is what got us into this situation in part, and there are different mechanisms we can discuss and people favor different versions of that story but that is clearly part of it. And you should address the underlying issue here, the underlying issue of imbalance, and there are sensible policies out there that countries have committed themselves to or said they want to do over the medium-term and I think there is plenty of opportunity for doing that even while they adopt sensible counter-cyclical policies. I think the goal for everybody is to sustain your domestic growth, subject to keeping inflation under control. That is good for your domestic economy and that is what is good for the global economy, and I think that there is very much a feasible set of policies out there. It is not easy because of the inflation concerns and other potential points we can talk about, but it absolutely can be done and there is something for everyone to do. Leading industrial countries and leading emerging markets have got plenty they can do in this space.

Just a couple more points before I end. There is a lot of interest in what is happening to allocation of resources into reserves. The IMF's so-called COFER database had its latest release of data at the end of December and that showed a somewhat reassuring picture in the sense that there has been relatively small change in the balance of these reserves out of the U.S. dollar and most of the change is to valuation effects or the fall in the value of the dollar. But there is also an underlying worrying sign which is these data cover a declining fraction of global reserves. I actually do not know, I am not allowed to know, which countries are in the data and which countries are not, but you could do the calculation and you can see that there are some important large holders of reserves who are not in this and it is very hard to know what is going on in the global economy. When people ask for my opinion on are the flows stable or unstable I say it is increasingly difficult when you do not know exactly the portfolios and you do not know exactly what people are doing.

It is like taking your car to see the mechanic and saying could you check out this car for me and he or she goes to open the hood and you say, no, you cannot do that. You cannot look at the engine. The mechanic can tell you it is a nice color, tires look good, but if you cannot look at the engine it is very hard to know what is going on.

So we think this is okay. We think there is not a major rebalancing of portfolios. The flows into the U.S. seem to be all right although they are shifting in interesting ways that we can talk about, but it is hard to know for sure. As more and more of these financial flows go into forms that are not picked up by our data, it becomes harder and harder to know exactly.

There is one more chart and it is a great chart, it is just not coming up. If you look at the handout which hopefully has been passed around that was available, the last picture is called Global Risk Factors. This is our attempt to be honest with ourselves and honest with you about where we think the various risks are coming from. We took it out because it is so confidential. So there is the global risk chart. I'm sorry. I guess there is a global risk chart. I think I was planning to show it but not hand it out, so I guess it got taken out of the presentation too. If you could see the chart, this is published in the World Economic Outlook, and it shows you where we think the drivers of risk are coming from and how we think these are shifting. We think relative to what we said in October that the downside risks from financial conditions have actually worsened. The downside risks relative to our baseline, and we have marked our baseline down a lot, there are still downside risks in the U.S., but it is a little less of a risk than in the October World Economic Outlook, the same thing for domestic demand in Europe and Japan, and there is still some upside risk in emerging markets. It is possible that emerging markets could just power through this, that they have got enough dynamic, they have really made a lot of progress in terms of policy frameworks and in terms of developing their own ability to withstand shocks, and their own space for countercyclical policy, for example, is much more substantial than it has ever been in the past. We do think that as the global economy comes down, the inflation risks are receding. I have included all markets in that because, again, as I expect global growth to fall, I think that will take demand off the oil markets.

The global imbalances though remains a big issue and I don't think the global imbalances risk is moving in the right direction. I am not concerned by attempts by countries to use countercyclical policy in a sensible way within their existing monetary and fiscal policy frameworks. I think that is completely sensible. I am concerned when any country or any set of countries says we do not have to worry about these imbalances, we will come back and deal with that in a few years. I do not think that is a good idea. I think we should keep our eye very firmly on that ball even while addressing and coming up with sensible countercyclical policies that can help in 2008 and 2009. Thanks very much.

MR. BAILY: Thank you, and it is a pleasure to be here and get a chance to talk about these issues. I am not going to say a lot of inflammatory disagreement with Simon. I agree with the things that he said. I will make a few comments particularly with respect to the U.S. and I will say a little bit about the Euro Zone as well.

Let me start by focusing on the U.S. As you know, we had a weaker-than-expected number in the fourth quarter of .6. I think that is because consumption was marked in a little bit slower than we had thought with the December number coming in weak. There was probably more of an inventory swing than had been expected. Net exports were a fair bit weaker than the third quarter, but I think that was to be expected because there had been such a surge of exports in the third quarter. I would forecast about 1-1/2 percent growth in the first half of this year, maybe rising to about 2-1/2 percent. But I think the high probability range for the U.S. economy is in the sort of plus 1-1/2 to minus 1-1/2, so I think the risks are essentially concentrated on the downside and potentially even below that if we got a deeper recession.

I think it is just very hard to tell right now whether we are going to slide through with a modest amount of slow growth or whether we are going to go into whatever the NBER will subsequently call a recession, a couple of quarters or three quarters of negative growth. I think that is the sort of range, about an 80-percent probably, will be in that plus 1-1/2 to minus 1-1/2 range. I realize that is quite a difference certainly in Washington in the political debate between plus 1-1/2 and minus 1-1/2, but I think there is so much uncertainty out there at the moment that it would be very hard to call exactly within that range. So when I say I think maybe we will get around 1-1/2 for the first half of the year, that is sort of my I think general optimism. I think probably the expected value is much closer to what Simon talked about that they had .8 as a fourth to fourth number.

What is the argument for no deep recession? I think the first argument is even though consumption is slowing, the U.S. consumer has been very resilient. We have not seen a massive slump in consumption since the early 1980s. When Americans get nervous they buy SUVs rather than saving a lot, so the U.S. consumer I think has been the main resilience in the U.S. economy.

Labor markets so far have not slumped. The numbers that came out today were not too encouraging, but I think it is still fair to say we have not seen a collapse of the labor market. So as long as that holds up, that is going to support not rapid consumption growth, but continued consumption growth. Net exports are providing their appropriate role as an automatic stabilizer and since the dollar has come down substantially, this is I think a source of growth going forward of exports, and imports being somewhat slower. Government spending which was fairly weak in the fourth quarter is likely to be another continuing source of growth. And I think if you look at the dynamics of the deep recessions that we had, the two that we had in the post-war period in 1975 and 1982, both of those dynamics were driven by inventories and inventories are a much smaller part of the economy today. I think there are also better methods for handling inventories. So I do not think we would get quite the same inventory dynamics now that we had during those episodes of very deep recession.

Another reason I think to say that we probably will not get a 1982 or even a 1975 kind of recession is that those recessions and indeed virtually all U.S. post-war recessions were associated with the Fed putting on the brakes. Obviously the Fed did put on the brakes for a while, they did want the economy to slow down, so they started this episode of economic slowing, but right now they have got their foot pretty firmly on the accelerator and so the idea that we are going to drop into a 1975 or 1982 kind of recession with the Fed lowering rates dramatically and a fiscal stimulus coming in again strikes me as a low-probability event. Headline inflation as Simon said has kicked up a little bit, the fourth quarter was not so great, but core inflation and inflation expectations still look fairly okay and the Fed is certainly not acting as if they have to take actions to dramatically clamp down on inflation.

So those are the reasons why I do not expect a deep recession. But having said that, being an economist on the one hand, and on the other hand I am going to talk about two possible reasons why we might get a deep recession and how those scenarios would play out. I think the first and most likely reason why we might get a deep recession is if we had a significant further deterioration in financial markets. I think Simon has probably mentioned the things that we are concerned about. In particular, the bond insurers, some of them are in trouble or already in bankruptcy, and when that role drops out of the economy, then there will be a downgrading of some of the debt that they were insuring which will force additional write-downs of financial institutions. Secondly, some of the financial institutions may have another shoe to drop. In other words, they may have write-downs that they are going to be taking. I think particularly we do not know necessarily the whole story on these structured investment vehicles so it is possible we are going to get another substantial write-down. And default swaps are another area of concern that I think Simon mentioned. So if you think there is a deep recession coming, it probably would be associated with another step down on the financial side and if that happens obviously that is going to curtail spending, investment spending, potentially consumer spending as well which will make the housing situation even worse than it already is, although that is hard to imagine, and that would then lead to bigger drops in consumption in the labor market and you would get the normal business cycle dynamics.

If I can trace out the scenario, why don't I think that is the most likely or why don't I think that is going to happen? There are a couple of reasons. The first is that most of the financial institutions are still doing okay. They came into this downturn with a lot of reserves. They were very profitable. I think this is a different situation than we had in the 1980s where a lot of financial institutions, their underlying profit proposition had been eroded and they were short of money. Now we have financial institutions that have been very profitable. Even the ones that have not been very well run have made a lot of money. So they are going into this with a lot more reserves.

The second reason is that we are having a very active monetary policy and I think potentially the Treasury would be willing to step in to try to prevent that second step-down in the financial markets by providing some kind of guarantees. I see the Congress is sort of thinking about whether they need something like the Resolution Trust Corporation, what we had in the 1980s. I do not say that is imminent, but I do think that both the Fed, the Treasury, and I guess a third player, Congress, would quite likely try to step in to prevent that from happening.

The second recession scenario which obviously still involves some of the same dynamics around consumption and the labor market would involve something initiated out of consumption being derived from housing wealth and the decline in housing wealth. There has been forecast, and it was something that Simon mentioned, that housing prices could fall 20 percent as a result of this crisis. If you knock off about $4 trillion of that household wealth, and then you say what is the margin or propensity to the consumer out of housing wealth and then you start to think about a $200 billion cut in consumption which might be enough given the already fragile nature of economic growth to trigger a more serious recession dynamic.

Why don't I think that is the most likely scenario? The first reason is that it would be pretty slow to unfold. Housing prices in the U.S. do not typically fall that dramatically, you get a drop in the volume of housing, housing prices undoubtedly will be weak, we may sort of look back and say they are 20-percent lower than they would have been had we not had this housing crisis, but it will be something that will unfold over 2 or 3 years and that allows Fed policy and fiscal policy to act to sustain the economy while that process is playing out. The second reason why I would not put a high probability on that as causing a deep recession is that housing prices have been so high. I do not think we have spent all the money we got from the run-up of housing prices when prices were so good. I do not think American home-owning households, and I am not speaking for the folks in Michigan or some of those places, but for the bulk of American home-owning households, I do not think they necessarily feel house poor. If they just bought a house and they took out a 95-percent mortgage, than obviously that is a different story and that is the fraction of the housing market that we are hearing a lot about. But in terms of overall consumption, I think many of us saw some of these price increases almost as funny money, a little bit more like stock market increases and decreases, that maybe would have a somewhat smaller effect on consumption.

So for the overall evaluation, I think there is about an 80-percent probably that we will stay within that range of plus 1-1/2 to minus 1-1/2 before we get back more or less to potential growth. Maybe there is a 5- to 3-percent probability that the U.S. economy will actually recover more strongly than any of us think at the moment, so about a 15-percent probability that we would get a deep recession. Probably not as deep as 1982, but maybe larger than we had in 2001 or in 1990.

Let me say a word about the Euro Zone, and it will not be much more than a word. The Euro Zone clearly is also slowing, and I agree with Simon's comments about the Euro Zone. I would note that a slowing of growth in the Euro Zone was something that the European Central Bank has been looking for because I think it was also noted potential growth in the Euro Zone is pretty slow so that had we not had this financial crisis, had we not had the substantial rise of the Euro against the dollar, then I think the European Central Bank would have been raising rates in order to slow the economy down. So they have been able to sit on their hands and not do that because the market has sort of done it for them in terms of what has happened to the U.S. situation and because of what has happened to the value of the Euro which is clearly having a dampening effect on demand in the European economy.

Let me follow that with a little more about potential growth. I was just recently at a conference at the European Central Bank where we talked about potential growth and productivity in both the U.S. and the Euro Zone. I think most of us in this room probably know that the potential growth rate in the U.S. seems to have slowed down. It was running at estimates of around 3-1/2, and now I think we are seeing estimates closer to 2-1/2, maybe 2-3/4, somewhere in that range. Why is that happening? It is happening because we are seeing much slower hours growth, the labor force growth has slowed down, and we also at least at the moment are seeing productivity growth. Whether that is a decline in the productivity trend I think remains to be seen, but it may be, and certainly actual productivity growth has been slower in 2005, 2006, and 2007, so that that has had a fairly dramatic effect. By the way, that is the kind of thing that makes at least small recessions more likely because if your trend growth is like China's at 10 or 11 percent, then you have to have a really massive downturn before you actually get into negative territory. So at a slow potential it makes the stalling speed a little easier to reach for the U.S. economy.

The thing that was surprising to me in the effort I made to look at the Euro Zone was that I did not see any evidence of an acceleration of potential growth in the Euro Zone either, or maybe even a slight decline in potential growth in the Euro Zone. It turned out that that is also the view of the European Central Bank. It is also the view of Bart van Ark who some of you may know as an economist at Groenigen on the Conference Board who has done a lot of work on this issue, and various other people. There were some dissenters at this conference, notably the Bank of France, and as you know, Sarkozy has been urging the European Central Bank to allow a little faster growth. So they are backing that up with analysis suggesting faster Euro Zone potential growth, but the rest of us I think did not see it. Productivity growth still looks pretty weak in the Euro Zone overall. It does vary quite a bit. Germany's manufacturing has done quite a lot of improvement, Germany and France generally have had faster productivity growth than Spain and Italy where it has been dreadful. The U.K. which is obviously not in the Euro Zone but in Europe has also had faster growth. But the overall potential seems to have stayed fairly slow which I think is rather disappointing as one might have hoped that some of the surge in productivity growth that the U.S. experienced after 1995 would have crossed the Atlantic and led to stronger potential growth and stronger productivity growth in the Euro Zone, and it may have, but it is certainly not that evident in the data that we have so far.

I think the last thing I will say is that on oil prices, and I think I am probably just going to echo what Simon said. In previous outlook sessions which we used to do when I was across the street, what was going to happen to oil prices was typically a very central consideration and were the increases in oil prices going to bring about a slowdown in the U.S. economy or in the global economy. We seem to have learned as a result of that that oil prices do not have the effect that they used to have either on core inflation or on economic growth. We seem to be able to ride through the rise in oil prices. Of course now we are slowing down so maybe one could say it is beginning to have an effect, and certainly to move up to $90 or close to $100 a barrel has not helped sustain growth in the U.S. or in the global economy. In the Euro Area of course where the Euro has risen has not seen as much of a rise in oil prices as the U.S. or other dollar-based countries.

It does not seem like an environment of slowing economic growth is a situation where an oil price spike is going to be a big source of downside risk. The qualifications to that are first of all China still seems to be plowing along and they are generating a lot of the growth in oil and energy demand so that I agree with Simon's evaluation and even though the world economy is slowing, there is not much sign at this point that we have got a lot of slack in oil markets. Then there is still the possibility that we might get some kind of disruption. It is still true that many of the countries that produce oil are in politically unstable situations and we could get a downturn from that or we could exacerbate the downturn. Another big oil spike if we were to have it would certainly be enough to trigger a somewhat deeper recession in the U.S. and probably globally. Let me stop there.

MR. KHARAS: Thank you very much, Simon and Martin. We've got about half an hour or a little bit longer than half an hour now for questions. I think we have had two really great presentations and I thought that maybe we can kick it off by first turning to you, Simon. You talked a little bit about how emerging markets and developing countries could power through this. One of the things that really struck me in looking at your numbers is that if you had come out and said the world economy is going to grow by 4.1 percent and you had made that announcement in 2003, everybody would have been cheering. If you think about it, 4.1 percent is much higher than the average global growth over the last 20 years. And you juxtapose that against all the negatives that come out about these crises in banks and this and that, so I was wondering if you wanted to say a little bit more about what are the strengths of the global economy right now and are these short-term strengths or are they something that might be undermined by the global imbalances that you talked about.

MR. JOHNSON: I am going to stand up to answer your question because I see people in the back in uncomfortable and unsustainable positions in order to see us.

I think that that is an extremely good question. Should we be disappointed with 4.1 percent growth absolutely depends on what is your reference point. Compared to 4.7 or 4.9 last year not so good, but if you go back to 2001, or if you go back to say the late 1990s, emerging markets in crises, a rolling series of problems and you compare it to today, today looks pretty good. What has happened over the past not just 10 years, the past 20 years, is this process of globalization that obviously has many sides to it and has plusses and minuses has brought a lot of labor into the global economy not just in China, also in India, also in emerging markets, and this has been very good for global trade. It has created some great gains from trade for industrial countries. It has also created some real potential for sustained growth in emerging markets particularly once they got their policy frameworks adjusted in order to deal with and manage the instabilities that come with the global economy.

We think what has happened are a couple of things. First of all, that global growth has this sort of self-reinforcing feature that has pulled up commodity prices and that is very, very important for many lower-income countries, non-oil commodities are a key driver of growth. One thing we are going to look at in our spring World Economic Outlook is exactly that, commodity prices and what could happen to commodity prices from this point. It is true that in many poorer countries, for example, they have improved policy frameworks, they have a much more resilient set of public finances, they have also brought down inflation and inflation expectations, but they also depend a lot on commodities. So it is possible that while people have made a lot of progress on the policy side and this is one reason why we have this resilience now particularly in the big economies, there is still vulnerability both to big enough shocks they do not have enough experience dealing with, countercyclical policies, for example, is a very new concept for China or India to think of themselves as -- I would say they should now think of themselves as potentially managing countercyclical policy in the way that the U.S. or Europe does. Obviously there is a different nature of their economies, different growth rates we are talking about, different kinds of inflation mechanisms, but countercyclical is absolutely possible for them, but that is new. At the same time there are commodity prices and what is going to happen to commodity prices. If the world slows down enough, that is going to be an additional problem particularly for poorer countries. So I think I agree with what I understood to be the thrust of what Homi was saying, which is there is good reason to expect resilience, but let's not overdo it, there is also vulnerability, and I really think we should feel uncomfortable about the imbalance of savings and investment. There is a lot of saving being generated in some of these fast-growing key Asian countries, China is an obvious example, but it is not just about China. That saving has to find a home somewhere and be used if you want to sustain global growth rates or when global growth rates come down, you have a lot less saving and you do not want that to be the mechanism through which you adjust current imbalances through having a much bigger fall in growth. I hope I dealt with the question.

MR. BAILY: If I may one comment on that with respect to China because China is obviously so large and is growing so fast and has a very large imbalance. In the U.S. we tended to focus on the bilateral imbalance, but now China has a very large current account surplus that has been growing from 2 percent to 4 percent to 6 percent, up to about 12 percent of GDP. So I think there is a very significant adjustment challenge for China to make to try to shift to being a somewhat more consumption-oriented or domestic-growth-oriented economy and away from excessive reliance on export growth. I think over time China is going to adjust its currency. It has adjusted it a little bit, although as you saw from the chart not very much. I think it is going to have to do more of that because it starts to break down. As you go from 12 percent of GDP, 14 to 16, something has to give and I think then that becomes quite a challenge for them to reorient the economy a little bit more toward domestic growth and less toward foreign growth while still maintaining what they need to do in terms of generating jobs as they restructure the economy.

MR. KHARAS: Martin, let me push you a little bit on that, because in this new world, I think if you take these new WEO numbers, developing countries account for 70 percent of total global growth. And if you look at the change in U.S. exports, they are only accounting for about 20 percent of the incremental U.S. exports, so there seems to be a structural problem. You talked about net exports emerging as a stabilizer for the U.S., but I am not sure that the U.S. is able to really take advantage of this tremendous growth in developing countries.

MR. BAILY: The WEO weights which are PPP based, and that is a perfectly sensible way to do your estimate of global growth, I think if you are looking at trade and contributions to growth from that point of view, I think you would want to use a more exchange rate weighted measure of global growth. And certainly the bulk of U.S. trade is still I think, certainly U.S. exports, are still with advanced countries, with Canada, with Latin America not so much and not so much with China.

Is the U.S. able to take advantage, is your basic question, of the growth in emerging markets in order to expand its exports. I am an exchange rate guy. I think that the problems we have been talking about with U.S. competitiveness and the difficulty of the U.S. being able to export, its share of exports has gone down, we have been driven out of a number of industries, I think a lot of that is because the exchange rate was out of whack. Obviously the exchange rate is market determined so if the capital is flowing in, in some sense that is the equilibrium exchange rate, but it was out of whack with anything that corresponds to trade competitiveness. As the dollar has come down and if it makes further adjustments against the currencies of the Asian economies, China particularly and maybe to some extent Japan, then I think you will see the exports growing. I do not know what share will go to Asia or to some other countries, I don't know if I care about that, but I think you will see the export growth.

MR. VAN AGTMAEL: My name is Antoine van Agtmael. I run a firm called Emerging Markets Management, so I am particularly interested in the emerging markets side. I hate to do this, but I want to throw some cold water on the idea that emerging markets are going to bail us out because simply said, I do not believe it. Let me explain why and then ask you to comment and see whether you have a very different view.

First of all, when I look at global growth and you cite this number of 4 plus percent, I presume that you are taking a PPP weighted basis. I think that is misleading, personally. I think it overstates the real impact of emerging markets in the global economy. Number two, there are really two drivers besides internal consumption in the fact that they are much better managed than they used to be for the success of emerging markets in recent years. One is commodity prices which were partially coming from their own demand, and the other of course was world trade and their increase in share of world trade which has been quite rapid.

I just did some analysis on let's say world trade and emerging markets exports relative to what happened in the U.S. in the past. There is no exception to the fact, and I do not believe in this decoupling theory, that every time if there is a big problem here, there is a big problem in terms of a significant slowdown in world trade and a significant slowdown in exports from emerging markets so that one of these engines starts to falter.

Then we look at countercyclical which is the third argument that you made which I also do not believe in. I should be very optimistic about emerging markets I am a big investor, but I am not. The countercyclical argument I do not think works either. Look at China. Can you invest more in China particularly given mounting inflationary pressures, given the fact that the premier himself says the economy is unbalanced? There are some other issues at the moment that are more of a temporary nature. It is hard to believe that China that is already growing well above its cruising speed through countercyclical measures could grow even faster when probably the monetary authorities do not want to do that so that you have the biggest emerging market economy where the risk is I believe on the down side. Then you take India where not only the reserve bank governor is not particularly eager to lower interest rates but where already things are going gangbusters. How much more gangbusters can they go? Then we look at Brazil where there is a real problem with food prices, and at least when I spoke recently to the central bank governor, he was inclined to tighten rather than to loosen, and where there is not much room for a lot of additional infrastructure spending except perhaps in energy. And by the way, the infrastructure spending of emerging markets which is now greater than infrastructure spending in the United States or Europe has been growing at 20 percent for the last couple of years. How much faster can it grow as opposed to 6 percent a year which is actually a negative rate if you take the cost increases into account? Then finally, Russia, which according to some estimates I have seen is beginning to let's say go from a huge current account surplus to maybe in a few years to not so much of a current surplus. So how much room is there there?

So on the three points, commodity prices, world trade, and countercyclical, I see much more down side than up side. Perhaps you could comment.

MR. JOHNSON: Thanks for the question and the points you made. I think that those are all good points. Remember, I only showed you my forecast through the end of 2008. I am not talking about 2009. We can come back in April and talk about that. I think the issues you raised are going to be very relevant to what happens going forward.

I think that the issue for 2008 is one of momentum. I am not asking or expecting emerging markets to pick up. In your statement you said China would be comfortable with some slowing down and that is what we saw in the fourth quarter actually, they got the growth down a little bit and they are very happy with that and I think they should be. I think the question is their growth going to remain at this level in 2008 or are they going to fall off precipitously in 2008? You could imagine scenarios in which it does fall off precipitously, but I think those are scenarios where there is what I might call an unfortunate sequence of events, some of which Martin talked about, further financial turmoil and so on and so forth.

There are some inflationary issues and I am certainly not downplaying them. I think you could also play it too far the other way. There was an increase in Chinese prices last year were food prices, particularly pork prices, as a measure of core it is lower. I think and the Managing Director of the IMF said this at Davos, there are in some instances scope for using fiscal policy, perhaps changing the mix between monetary and fiscal policy. Inflation is always a constraint on that ability, but I think emerging markets should have more confidence in their ability to avoid the rapid slowdown. If the U.S. comes down more or if it stays down or if Europe comes down more, I completely agree with you on your bigger picture which is commodity prices come down, global growth slows down, no question, and then it is very hard for anyone to be immune and I do not think the big emerging markets as you said could pick up their growth enough to make up for the slowdown in the advanced economies. Then I think we are in a different scenario. I think of that as more of a 2009 issue. I think that in 2008 these large emerging markets will keep growing. Coming down a little bit would be fine as you said. There is nothing wrong with that, but I do not think we are going to see big slowdowns unless we see some more unexpected rapid financial repercussions.

MR. BAILY: Let me comment on are the emerging markets going to bail us out, and let me qualify a little bit what I said. I hope this is not a flip-flop, but even if it is, I am economist so we do it all the time. I did say I think that the exchange rate is probably the biggest thing that is going to help turn around the imbalance in the U.S., but obviously exchange rate is an endogenous variable, so if thing change, flows of funds change, then the exchange rate will change and if the dollar starts to go back up again we will not get adjustment of the imbalance and exports will be less than a source of growth.

The second qualification is that obviously the exchange rate is not the only thing and certainly not the only thing in the short-run, so if indeed you are correct, if I understand what you were saying, that you might have a global recession or a global downturn that is more severe, obviously that is going to dampen U.S. growth, that might be one of the factors that would lower U.S. growth some.

I think we had an earlier question, U.S. exports to emerging markets is not our main destination although exports to China I think have been a big source of export growth, but the direct effect of slower growth in emerging markets, what does that do to exports or what fraction of that is U.S. GDP, I think it would look fairly small, but obviously it is going to be a factor. So if there is a global slowdown, if Europe goes into recession, if emerging markets go into recession, then certainly exports are not going to be a big source of growth for the U.S.

MR. OWEN: I am Henry Owen. I used to work at Brookings. I would like to raise three points. First, on the question of consumption which you have listed as one of the weak points of the U.S., it seems to me the objective policy should be to make it even weaker. If we are going to redress the international imbalances, you need less consumption in the U.S. and more investment, just as you need more consumption in Europe and less investment. So consumption should go down and will go down and that is good for economic growth in the world.

The second point I want to speak to is the question of oil. I know something about this. I think oil will remain very high, but the problem with oil is not discovering oil, it is bringing it in pipelines. The business of making the U.S. self-sufficient is a pipedream as both President Clinton and others have found. It just will not happen. The oil has to come from where it is which is the Middle East, Azerbaijan and so forth. We do not have enough pipelines, and for that we need more investment and more forward activity.

The third like I would like to speak of is the developing countries. I think you find a tremendous disparity there. India and China seem to me terrific. Both of them used to have large barriers to foreign investment. They are largely gone and the Indian government is favorable of the private sector in a way that Nehru never was, and the Chinese government has open arms to private investment. So I think in that respect things look very good. What worries me most about the developing countries is U.S. protectionism which none of you mentioned but which I think is a growing force in the U.S., and it will become more and more difficult for U.S. firms to invest in China and India workers will say you are taking our jobs away from us. It will more and more difficult for us to buy their agricultural imports and U.S. farmers will say they are taking (inaudible) so those are the three things I would like you to speak more about. How are you going to get consumption down in the U.S. and investment up so we can redress international imbalances and see how are you going to get more oil pipelines so you can get continuing oil to meet the increasing demand for oil? And third, how are you going to beat protectionism in the U.S.? I am a Democrat, but I am ashamed of my own party (inaudible) unless you can do that, you certainly will not have a bright future for the developing countries.

MR. JOHNSON: People at the back, were you able to hear the question?

MR. KHARAS: I will summarize the question. There are three questions, all very good questions. The first one is shouldn't we expect or hope for a bigger and sooner adjustment in consumption relative to investment for example in the U.S. as part of addressing the global imbalances and providing for more savings for U.S. investment.

MR JOHNSON: First of all, I think that household savings are going to go up in the U.S. Whatever they think about house prices, they are not expecting them to increase a lot over the next 5 years. That is my guess.

It is a little bit like lending standards. We would like savings to go up but not too much too soon. We would like lending standards I think to be tightened compared to what they have been over the past 5 years but not too soon. I completely agree with you on the medium term and I think the adjustment mechanism is already working in the right direction, but you do not want to have what people call the financial decelerator, something actually that Mr. Ben Bernanke built part of his academic reputation on, studying the role of the financial accelerator, the way the different parts of this accelerator or decelerator in this case play off each other and I think that is the basis on which we are supportive of what is likely to be the fiscal stimulus for the U.S. in the second half of 2008. We think it is a reasonable risk-management approach. It is a temporary stimulus. It is targeted in a way to keep consumption up and to try and take the edge off this financial deceleration while we think and we are certainly emphasizing the need to stay on the medium-term trajectory for the U.S. deficit, that is absolutely critical, and we think that this will help get through the phase where full monetary policy can become fully effective because money policy I think is a little less effective now or working a little less quickly than it has in some previous instances.

So the answer to your question is, yes, in the medium term, but in the short-run, the IMF and others recognize that you can have sensible countercyclical policies particularly from a risk-management perspective it is risky, sorry about that metaphor, but at least that is our position. Let me go through all three before I forget.

MR. OWEN: You remind of Saint Augustine.

MR. JOHNSON: Exactly.

MR. OWEN: He used to say, Do you want to go to heaven? and he said yes, but not too soon.

SPEAKER: I thought he said, Lord make me chaste but not yet.

MR. JOHNSON: Any analogy between the IMF and Saint Augustine --

MR. OWEN: You can accelerate the process. I happen to think that Saint Augustine was a great man, but you can accelerate the process by tax policies which makes long-term investment more rewarding and this involves something which is not popular which is reducing estate taxes because most people hope to make money not for themselves but for their families in the long-term future. So you can accelerate it by tax policy.

MR. JOHNSON: As long as we agree that fiscal consolidation remains a very important medium-term goal for the United States and that a great deal of progress has been made and it would be inappropriate and unfortunate to give up that progress, that is why we are supporting a temporary fiscal stimulus, then I think we are okay, we are on the same page.

The second question was about oil and it was with regard to whether we need to have more investment in pipelines as well as in oil production capacity around the world, and I am sure you are right that there are important capacity constraints and we have certainly seen this in the dynamics of both the oil market and the gasoline market in the U.S.

over the past 12 months, for example, have been very much driven by lack of capacity and refining and in pipelines. And there some long-term concerns of course about the amount of shipping capacity around the world although I would note that some of the leading indicators of the price and volume of shipping capacity seem to indicate that as world growth is slowing and people have been (inaudible) this is going to come off.

I think that this is an important issue and it is striking that OPEC and some oil companies have been reluctant to invest in this environment. There is a debate about why this is. One possible explanation is that uncertainty about biofuels policy in leading industrial countries has created more uncertainty than there should be about the likely future of oil prices. I do not know if I fully buy that explanation, but I do think that in the context of a full overhaul of environmental policies which is very much what I hope all countries in the world are going to be undertaking in the next couple of years that leading countries such as the United States but not only the United States think very hard about what kind of biofuels policy are they going to adopt and then lay out some parameters to give greater certainty for everyone including people in the upstream and downstream part of the oil business and take that piece of uncertainty out of the planning and investing in the oil business. Obviously you have to have a long time horizon in the oil business. If you feel that the U.S. is going to make a massive switch into alternative fuels, that is going to discourage you from investing. So I think that piece could be taken out.

The third question was U.S. protectionism. I should start and end every talk that I give with exactly the point you made which is the big thing to fear here is not fear itself, that is always a problem, is protectionism and U.S. protectionism is I think a very real threat and I think it would be a disaster for the United States and for the world economy. It would not at all have the positive effects that are claimed for it. And I think that organizations such as the IMF were created in large part after World War II with the explicit goal of avoiding and preventing that kind of outcome, a retreat into protectionism and competitive devaluation and the whole package that went through in the 1930s. Some people say why do we need an IMF anymore? The world has become more stable. Actually, fewer people say that now than they said it 6 months ago. But the main reason to have organizations like the IMF is exactly to prevent and to forestall and to encourage countries to take policies that do not lead toward this kind of protectionism. That would be calamitous and it is a very real that we should not underestimate and thank you for reminding us of that.

MR. BAILY: May I just make a quick comment? I agree with everything that Simon said. I agree with you that over the long run we have to lower the share of consumption in U.S. GDP and increase so that we can reduce the current account deficit over the long run. That is a long-run goal. That is one reason I have not been someone leading the charge for the fiscal stimulus because I think we are going to need more revenue or at least a change in government expenditure and revenues to be part of the solution to that. The oil pipeline, I do not think I have any comment. As for protectionism, the only thing I would add is that the fact that the dollar got so high relative to any kind of trade equilibrium was one of the reason why trade has become so unpopular in the U.S. because we have had this huge trade deficit. I do not think trade is ever going to be super-popular but if we continue to get stronger growth of exports or we get more jobs generated by exports, if import growth slows down, then I think that protectionist danger that you correctly identify is going to recede a little bit. I certainly hope it does. I am a Democrat too. I was in the Clinton Administration. We did not do very much protectionism, a little bit here or there, but generally I think Clinton had a very good record and I hope we can continue to avoid that kind of protectionism.

MR. KHARAS: We do not have that much time and we have a lot of questions. What I am going to suggest is that we take several questions and then the panelists can choose what they want to answer and what they do not.

MR. JOHNSON: Sounds good to me.

MR. BAILY: Yes, it sounds good.

MR. KHARAS: John, you are holding a microphone I see.

MR. WILLIAMSON: John Williamson from the Peterson Institute. I suppose I am going to betray my European origins in that it seems to me that a slowdown in the U.S. economy is just what the doctor ordered. The question is whether the slowdown is going to be excessive and one can surely dream up some scary scenarios like Martin did, but the question is there at this stage any concrete sign of those? Right from last summer we have heard all sorts of stories about how recession is coming but as I read the indicators, they are still very mixed and one still is not getting unambiguous quantitative evidence that there really is a major slowdown in the works and that is gone too far.

The second point I want to make is that if such a slowdown does eventuate then the big place to have counteracting action is going to be in big emerging markets and specifically in East Asia, specifically in China. I agree with Antoine van Agtmael that India does not have the conditions to engage in cyclical expansion at this point, but China does, and China also is the obvious place to have some of those savings utilized not so much in more investment but in more consumption because consumption is still low relative to national income and I am sure it is expanding but it is still low relative to national income and there are still a lot of very poor people in China and that is the place where one ought to be seeing more, and sure if there is not a major slowdown in the world economy then if this will only be possible with accelerated appreciation, but if there is a major slowdown in the world economy, then even without an acceleration in appreciation I think it is possible.

MR. HERRIOT: Judd Herriot, documentary film producer. Addressing the issue of solvency and looking at your chart on credit default swaps, given the fact that we have roughly $1.3 trillion in subprime mortgages which have given rise to $600 billion or so in collateralized debt obligations and God knows how many derivative products which have been spawned downstream from that, we do not know how many of these positions are toxic, but my question to you is, did you make any assumptions when you looked at this question on how long it will take international institutions to wind these positions down, these toxic positions, down?

MR. BRADFORD: Thank you. Colin Bradford from Brookings. Simon, I wanted to pick up just where you left off in your side remark about the IMF and how the world views it and wondered if you would comment on the degree to which the substance of this latest financial disturbance creates an opportunity for the IMF to step in and resume its role as a central player in guiding the financial system and whether you see the run-up to the Spring Meetings, the G-7 finance ministers' meeting next week and so on, as members pushing and taking advantage of this opportunity essentially to have the IMF play a role in supervising and monitoring even regulating or encouraging regulation at the national level in financial markets.

SPEAKER: First of all, thank you very much for the excellent presentations. I turn to emerging markets again and the capitol flow charts that Simon showed was from 2007. However, in 2008 and in this month alone we already saw almost $2 billion out of Brazil in terms of withdrawal in foreign investments there. My question is, is this also happening in other emerging market countries and what is the correlation between this kind of movement that has happened so quick with this global downturn?

MR. JOHNSON: Anything concrete on the recession? Of course, you are right, it is difficult to read and it is a tough situation. I think my view from some of the areas we talked about here is it is pointing in a negative direction. I think the latest indications on credit cards, both on rising delinquencies on credit cards and on the apparent move toward tightening standards by credit card companies, is worrying and I think we might see similar things on other loans. Obviously some of the government-sponsored and supported enterprises, Fannie, Freddie, Sally, have particular issues that are impeding them right now. And I am worried about credit contamination I think and the financial decelerator.

You asked about China and you asked about the scope for countercyclical policies. By the way, the Indian finance minister who was on the same Davos panel as Mr. Strauss-Kahn did actually say he thought that under some circumstances India would have scope for a countercyclical policy. Again, we are talking about if there is a big global slowdown, does India have the policy space to address it? He said yes. You can look at the webcast and make up your own mind.

China I think agrees. Every indication we have is that they agree exactly with what you are saying, that there is room to increase consumption, there is room to support domestic demand. They are trying to figure out how to do it. In fact, as you know, in one of your favorite international agreements or international discussions of all time, John, the Multilateral Consultation, the Chinese said that, they agreed with you. Now how to do it and when to do it. The global slowdown makes it a little bit more pointed, right? It concentrates everybody's minds on it and that is something in which we are engaging with people going forward.

And let me just jump to the IMF question. I think the IMF role has changed many times since the 1940s and it continues to change and I think there is a discussion about who should have what kind of responsibility moving forward. There is the Financial Stability Forum that is tasked with trying to think about a lot of these regulatory issues and pulling together some of the lessons. There are clearly spillover issues between countries on positions of macroeconomic policy response. I think there is a debate about that right now. There are no easy answers and nobody has necessarily the right answer, but the IMF is very much engaged in that debate and I think you will see a lot of debate and thinking about that in and around the IMF and other places as we go through the Spring Meetings and the summer and into the Annual Meetings. I think those are first-order issues and we are not claiming a monopoly on confidence at all, but I think we are going to be engaged and we are going to be talking to all our member countries about this countercyclical issue and who has fiscal space, who has macro or monetary space, under what circumstances should you use it, could you use it. Those are critical questions. If you built policy credibility which we say people have, you have credibility for a reason. You want use it when it is appropriate and you have to have an understanding of when it is appropriate. And by the way, the first reaction of a lot of countries to our statement on this has been, yes, you are absolutely right and our neighbor is the prime candidate to do this. That gets tricky. Somebody has to come and say here are the criteria, here are some ways to measure it, here are some ways to discuss it, and I think the IMF is going to be actively engaged in that moving forward.

The credit default swap spreads question, what is our assumption, we have released a Global Financial Stability report update as well on Tuesday and that lays out a lot of our current sort of baseline view on who has what losses and the process through which that is moving to be addressed. So I would suggest you take a look at that and if you have more questions you can ask me. I do not have time to go through all the details. The idea is there will be a fairly steady move to resolve these things, but it is not happening as quickly as one would like. There have been some delays and we have been talking for some time about the need particularly for European banks to speed up on their recognition of losses.

Our baseline takes some time to resolve fully and absolutely goes through this year. There is a substantial amount. I think the pace remains about the same in those assumptions as it has been so far which is certainly not rapid.

In terms of capital outflows, there is obviously a lot of volatility. Actually more broadly within emerging markets the indications we have are more inflows continuing with some notable exceptions. Is that good news or bad news? The more inflows you get depending on the form they come, the more potential outflows you have in the future and so I am very worried about the buildup of vulnerabilities. And I think there is a view among some member countries that just because they have a current account surplus they are somehow not going to be affected by reversal of capital flows. It is true that they will not be affected in the same way as before, but they find themselves making a big current account adjustment or forced to on short notice, and that is not good. They may also be building up vulnerabilities. In this issue of financial fragility, where do the savings go? As Martin said, if the U.S. reduces its deficit, that should go through hopefully some sensible equilibrium mechanism involving the exchange rate reduce surpluses. But there is another possibility which is that the surpluses remain the same and someone else comes up with the deficit, and those deficits could be in Europe, they could be in emerging markets, those would seem like the leading candidates, and those deficits could come with the kind of financial fragility we have seen in the United States. I think that our ability to manage these flows and to keep these flows from reducing perceptions of risk and preventing them from encouraging financial institutions to really take on way too much risk is quite limited. Do not think better financial regulation is going to solve the problem here. The underlying deep fundamental medium-term problem is there is a lot of savings in the world that are looking for a home, it gets reallocated and it finds a home, but it comes with financial fragility and that is a very important lesson over the last 5 years.

MR. BAILY: Let me make two quick comments, one in response to John's statement that the downturn is just what the U.S. needs. I am not a fan of recessions I have to say. I do think you are right, John, that we needed slower growth, we do need to make progress on adjusting the external imbalance, so I think there is some good coming out of the slowdown and the Fed was indeed looking for a slowdown for inflation reasons. I do not think a recession is something that we particularly want. Is there any sign of a recession? I am surprised you do not see any sign of it. After all, the housing market is falling through the floor, we have lots of financial uncertainty, the labor market is looking a bit fragile, expectations (inaudible) trouble, so I would not say there are no signs of it, but like you, I am not expecting a big recession so I guess I just would not agree that there are signs there at all.

This event is jointly hosted by the IMF and it is bad form to insult your host, but I am going to say that I think the IMF maybe together with institutions like the Federal Reserve and the U.S. Treasury should have played a more active role in if not preventing at least warning about some of these financial problems and some of the imbalances. I think the IMF maybe could have played a more active role, and maybe this was going on behind the scenes, in encouraging more flexibility of exchange rates and a more adjustment of some of these very large global imbalances. And I think it is a disgrace really that we did not take more action to prevent some of the abuses that happened around the subprime market. Some of you may know Ned Gramlich who wrote a very prescient book and was not able to convince people at the Fed or in other places that something needed to be done. A lot of these banks were regulated by the states, but I think the Fed should have stepped in to do more. So I think we have had a failure of our financial institutions and I would not put the greatest blame by any means on the IMF and even if I did it was probably before Simon went there, but I think we would like to have more from those institutions so that we do not get some of these crises in quite the severity we are getting them.

MR. KHARAS: I think we need to wrap this up. I am sorry to all of those who had wanted to ask questions and were not able to. Simon, thank you very much. That was a tremendous, though-provoking presentation. And thank you also for your frankness. I certainly appreciated hearing from an IMF Chief Economist that developing countries do have now space to expand our fiscal positions.

MR. JOHNSON: Potentially.

MR. KHARAS: I think that is a relatively new position. And hearing from you that there are vulnerabilities that are associated with some of these global portfolio flows. I think that is also something which is very new. So I hope when you come back in April you will be in a position to share the global risk management chart and then we will have real transparency from the Fund. Martin, thank you also.

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