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PANEL 1: THE EUROZONE: FROM CRISIS TO CONSOLIDATION?:

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P R O C E E D I N G S

MR. VAÏSSE: Why don't we start now? Hi, everybody. I'm Justin Vaïsse. I'm a senior fellow here at Brookings. It's my pleasure to open this 8th Annual Conference of the Center on the U.S. and Europe, which coincides this year with President Obama's trip to Europe. He's indeed in Deauville today at the G-8.

We will have three panels during the day to discuss the situation in Europe and also the situation of Europe in the world and also the transatlantic relationship in general. These three panels were prepared and designed in partnership with our friends at the Heinrich Böll Foundation and we are grateful to them for their help and support.

The first panel, as you know, will focus on the crisis of the euro, including its transatlantic dimension. The second panel will be a discussion between Daniel Cohn-Bendit, the well-known Franco-German politician from the Green Party and our colleague Bob Kagan. It will be about Europe's power in the world. And the third one will explore European reactions to the Arab Spring in the early afternoon, starting at 1:30, and what Europe and America have done and can do together to affect positively developments there.

So, let's start with this first panel and the state of the Eurozone. About exactly a year ago at the 7th CUSE Annual Conference, we had already held a panel on the state of the euro crisis which had begun, as you may remember, with the worsening of the situation -- of the debt situation in Greece in late 2009. The conference was held in very early June of last year just a few weeks after a large bailout package was put together for Greece by the EU and the IMF and rescue mechanism, the EFSF, was put in place to reassure the markets and prevent further contagion from Greece to other countries perceived as weak.

Well, it turns out that the markets were not reassured, not for some time. As you know, Ireland, and more recently Portugal, have had to be rescued by the EFSF among others. The failure to avoid contagion should not, of course, hide the fact that Europeans in the meantime, in the past year, made considerable progress at reforming the governance of the Eurozone and basically moving towards a closer union.

In March, just three months ago, the so-called comprehensive solution, agreed upon by

European governments, included a strengthening of the growth and stability pact, reinforced surveillance mechanisms, national budgets, and a more robust rescue mechanism starting in 2013 as well as a new round of stress tests for European banks. However, trust has not come back or not come back yet.

As you know, the Greek situation seems more intractable than ever and it seems that there's little chance that Athens could get back to the markets, even in a few years from now. European banks still don't inspire confidence. Public opinions are not happy about the measures that have been taken to rein in deficits and reduce debt; especially in Spain in the last few days and weeks, and more importantly we're still far away from getting the strong and resolute political leadership needed to reassure the markets.

So, where is this going exactly and will we have to hold a panel discussion at every CUSE annual conference for the next 5, 10 years?

To answer these questions we have really a first rate group of four distinguished panelists and I'll very briefly introduce them in the order in which I will ask them to do their introductory remarks.

First of all, it's my pleasure to introduce Beatrice Weder Di Mauro. Beatrice holds the chair of international microeconomics in the department of economics at Johannes-Gutenberg University of Mainz. She is one of the five wise men of the German Counsel of Economic Experts. She is actually not a man, and what's more, she's not even German, she's Swiss. However, she is wise, indeed. She's actually so wise that the German government overlooked these two flaws and she was chosen as the first non-German and non-man for this position where she advises the German government on economic policy with her four colleagues. I should add that, of course, she will be speaking here in her personal capacity only.

I will then ask my neighbor Lucas Papademos to weigh in. Lucas is currently a visiting professor of public policy at the JFK School of Government at Harvard University and a professor of economics at the University of Athens. More importantly, Lucas was previously governor of the Bank of Greece from 1994 to 2002 and then vice president of the ECB, of the European Central Bank, from 2002 to 2010. While he's sometimes (inaudible) the Greek government, he will also speak strictly in his personal capacity here.

Then we have two American observers with us. The next speaker will be Don Kohn, my neighbor here. Don is a senior fellow here at Brookings at the economic studies program. As the former vice chairman of the Fed, Kohn is an expert on monetary policy, financial regulation, and macroeconomics. Prior to his current position, he advised the Chairman, Ben Bernanke, through the crisis in ’08 and ’09 and also served as a key advisor to the former Fed Chairman Alan Greenspan.

Finally, after the Fed, the Treasury, we will hear from Ted Truman. Ted is senior fellow at the Peterson Institute, just across the street here, where he has been working since 2001 after serving as assistant secretary of the Treasury for International Affairs from 1998 to 2001. Previously -- he’s also Fed, actually, because he directed the Division of International Finance of the board of governors of the Federal Reserve System from 1977 to 1998.

So, these are the four panelists to which I will ask to enlighten us on the state of the euro and where this is headed, perhaps starting with you Beatrice and perhaps your general view of the situation and where this is headed.

MS. WEDER DI MAURO: Well, thank you very much, Justin. Thank you for having me here and, you know, related to your question of whether there are going to be panels about euro for the -- you know, for quite a number of years to come, I would think that this is going to be the case.

It is a situation which has not yet been resolved and it’s going to be very interesting for a number of years, not only from the policy point of view, but also from the point of view of analyzing what can actually work and what can’t work, and that was going to be my introduction because I just happened to teach these days -- actually, the first days of this week, of course, on optimal currency area theory. And for those of you that have been either on the teaching or on the receiving end of this type of theory, that’s our workhorse model of what one should do, whether a country should or should not join a common currency area.

And if you look at things from that perspective, you will see very quickly that our -- economics tends to be very quick about, you know, what the benefits are of the common currency, something to do with transactions costs that are lower, and then we focus very much on the costs, about the question of the incidents of asymmetries, about adjustments that -- when isometric developments happen in different regions or countries, how they can be overcome. And, in fact, when you start looking at this you quickly get the impression that there shouldn't be any common currencies anywhere, you know. I mean, you start really wondering why there are rather large currency areas, such as the United States, the more you focus on these costs and the question then is, you know, why -- then you could very quickly conclude that the solution is also quite easy, you know. Countries that are under pressure, such as, for instance, Greece, they should just leave, you know, exit, and in fact there have been some people suggesting Greece should take a holiday from the common currency, depreciate strongly, and then get back in or not get back in. I mean, just stay as a floater.

The problem is that I think what we do miss in this type of quick analysis is the -- enough of a focus on what are actually the alternatives. What are the costs of not having a common currency? Can you do it on your own? What kind of -- let's imagine we could do the transition without any cost, which is not the case, but what are the alternatives? Can you actually be a successful floater? Can you have the type of successful currency crisis and then devaluation and regaining of competitiveness as England had after '92? Or is it -- are you more likely to be in a situation that most emerging markets have been after currency crises in which they have huge balance sheet problems and they do not get back onto private markets for quite a while and they do suffer a large decline in output? And I would suggest that this is more the emerging markets, the alternative is much more what we're talking about and this is why to conclude, very quickly, that exit, or, you know, dismantling a common currency or even -- and, you know, as you may know, there are some sympathies for this kind of solution in Germany saying, well, let's reduce the common currency and let's have just a Nordic and let's let the periphery do it on their own. That the cost of such alternatives are really not thought through enough and that they would be huge, both for the countries concerned, as well as for the ones that stay inside.

So, by -- you know, if I -- by stating this I would say let's exclude the solution that -- one should not opt for the solution of exit for any of the concerned countries and therefore we are left with the types of solutions that are inside.

So, what are those? What are the alternatives that are available right now? Well, one is to continue on the path that is the IMF, EU, and ECB program right now which, of course, is in the case of Greece not faltering, but it's the strategy in general to do what usually the IMF does is to provide some financing and a lot of adjustment.

The problem, I think, clearly the most pressing problem is Greece because their original program of a year ago is now in doubt, whether it's financed and whether it's credible. And actually markets have concluded that it's not credible. They look at numbers such as 150 or 160 percent of GDP indebtedness, which it's going to be, as programmed at the peak and then starts to slowly move down, which also means that you have a primary surplus, have to have a primary surplus over so many years that you look at the situation and you wonder whether Greece is in any way -- whether one can actually ask from the country to be able to deliver those kinds of surpluses, primary surpluses over many, many years.

Again, I think markets have basically passed verdict on this and have said this is not credible and this is why we see these huge increases in spreads in the -- in whatever number you look at for Greece, be it the CDS or the 10-year bonds, et cetera.

What about governments in Europe? Well, in Germany there is a lot of sympathy for this argument, actually. There is sympathy for two reasons, one, because one actually does also look at the same numbers and says, well, this is something that is going to be in economic and political terms almost unbearable. There should be an alternative and the alternative would be restructuring. So, German, both economists, I mean also us at the Council, but also in governments there is sympathy for doing an earlier, rather than a later, restructuring. And why earlier rather than later restructuring of the debt? Well, in part because as long -- if you wait longer, the restructuring that may happen is going to be made in the official government -- with the official sector because right now, of course, the private sector is being repaid, all loans are being repaid at par. And if you look at the repayment schedule, you'll see that within a few years already the official sector is going to be the main creditor to Greece, and if this continues, then eventually it's going to be the only one.

So, a later restructuring rather than the earlier is automatically also a restructuring with the official sector of other European countries. I am assuming that the IMF would not be part of the restructuring and, therefore, it actually then would -- if this happened, would express to verify all the fears that Germans tend to have because they have been saying, when the crisis started, well, it's us who is going to be paying for this eventually. It's of course, not true. It's not only Germany, it's all the creditors, but Germany has a third of the pie, and so this is why in government in Germany there is a lot of sympathy for going for a solution restructuring. However, this is not really a majority view within other governments of the euro area, and of course it's not at all the view, as you probably know, inside the ECB.

Why is the ECB so strongly against a restructuring? Well, there are different reasons; the main one certainly being that the question is whether you can control the effects of having a restructuring in one country on the other countries. That is a very, very good reason, which also means that you could not just, you know, restructuring on one end and without having a plan for everything else.

So, if we take this one as a given, we need a plan for everything, then the real comprehensive solution has to have backstops for other countries, it has to have also a plan for other countries which are already on the program possibly. You know, Ireland and Portugal, what do you do with Ireland and Portugal if you start restructuring Greece? How do you backstop if there is further contagion?

And so if we start to think about it in this way, it means that a big solution is quite a complicated thing to organize. You need a lot of coordination. You need to coordinate the IMF, the ECB, the EU, you need to coordinate basically all governments because there has to be a -- almost certainly there would have to be a unanimous vote on this, and you need to -- that's usually the problem you have. You need to coordinate the private sector.

But this coordination problem here is much, much bigger than the usual coordination problem you have when you're thinking about restructuring private debt. And the problem right now in my view is that this coordination problem is not being solved. There was an attempt to have a secret meeting of finance ministers and it was blown, cover was blown, and so it was no longer secret. It actually resulted in a weekend of speculation that they were talking about the exit of Greece, which was not the case, but it was -- you know, it completely backfired.

There is right now no good mechanism for creating the coordination that would be necessary to coordinate on such a solution because too many things would have to be in place at the same time.

In my view what is needed right now would be one player that can take over this coordination. This could be the EFSF and the way it could be done is through a debt exchange between the private sector and the EFSF in the first place, and then a second step in renegotiating the program with Greece, I think that could be a feasible solution. The other thing is, you know, where is the IMF on this? Is the IMF -- the IMF, in many ways, is now a pivotal player because it depends on whether the program goes on, whether the next tranche is released or not. The IMF could also be this player that sort of forces the coordination, but the question is, can it do it right now and will it.

And finally there is the -- I'm done -- and finally there is the ECB. The ECB has to be part of any solution. It can't be done without the ECB because although the bonds that the ECB is right now holding in its balance sheet straight -- that it bought on the secondary market, that's not the main issue. The main issue is that the refinancing and the liquidity provision of Greece, but also of some other countries of the banks of these countries, is almost exclusively through the ECB. So, the ECB holds the card on whether the banking system is floating or is not, and if the ECB is not on board with a restructuring, it can't happen.

So, right now we are in a block situation. That would be my analysis. We need a pivotal player that can provide a solution. IMF could be one -- could have been, maybe.

MS. VAÏSSE: Thanks, Beatrice. I was hoping you would cheer us up for the introduction and then we would face some skepticism from the American side, but I didn't get it. So, Lucas, I'll try with you.

MR. PAPADEMOS: I'm not sure I'm going to cheer you up but let me first say that I'm very happy to be here. Thanks for the invitation. I think the topic of this session is becoming increasingly topical, unfortunately for the wrong reason, but I would agree with both of you that some more conferences on this topic are likely to be held in the coming years. I would hope, however, that it's not going to be very long string of conferences.

In my opening remarks I would like to say a few things on three issues that also Justin touched in his introduction, first of all, the general issue, where do we stand with the euro crisis and how is it likely to evolve? Secondly, I would like to focus on the policy challenges that are being faced in Greece in its efforts to resolve the sovereign debt crisis, and whether, despite the worsening of conditions, there is light at the end of the tunnel or, as some people think, maybe there is a train coming in the opposite direction.

And third, if I have a little bit of time -- otherwise I will do it in the discussion -- to say a few words on how the crisis management arrangements under construction in the euro area can contribute to the resolution of the crisis.

Now, where do we stand with regard to the crisis? Definitely the crisis is not standing, it is evolving very rapidly. It is evolving in an environment, which is collateralized by two opposing, rather contradictory developments. On the one hand -- and I think this is important to emphasize -- appropriate and bold action has been taken in all countries under market pressure over the last year, and also at the European level in terms of creating a new policy framework, strengthening, as we say, the “E” in the EMU, and also establishing crisis management arrangements. But at the same time there is increased uncertainty in the markets about the capacity and the willingness of countries to take the additional steps needed to reduce the fiscal imbalances and address the competitiveness problems.

And one issue that has been very extensively and intensively debated over the past few months and especially the last few weeks is exactly the issue of debt restructuring that, as I will try to say in a moment, has actually played a role in terms of intensifying the market tensions.

Now, over the past six months, as we know, the conditions have not improved, they have actually deteriorated in the markets as being judged both by the bond yield spreads and the CDS premium despite implementation and the continuous implementation, as I said earlier, of bold and important measures to reduce fiscal imbalances and improve the competitiveness of the economies. So, markets are not reassured, they have not been convinced that the debt dynamics will be sustainable in the long term, and also that the funding pressures will be addressed over the medium term.

Now, the key question in my mind is what policy actions, given these unfavorable developments, can be taken at the national level as well as the euro area level, in order to change the market sentiment? This is sometimes what has been called game changing actions, so as to enhance confidence in the markets, in the sustainability of public finances, and in the resolution of the crisis.

Now, let me make now a few remarks on the Greek case trying to address this question -- actually, two questions -- what are the factors that explain the deterioration of the market sentiment? And what can be done to address the situation? And then say a few words about actions that can be taken at the European level.

Now, it's almost exactly one year after the agreement of the financial support to be provided to Greece and the adoption of an ambitious economic adjustment program, and one year later the Greek economy and Greek policymakers are facing, again, I would say, extraordinary policy challenges.

Now, market conditions, especially over the last two months, have really deteriorated, and it's interesting to know that this deterioration, while market sentiment has taken place against the background over other impressive, but it seems also forgotten, reduction in the budget deficit in 2010 by 5 percentage points of GDP, as well as the implementation of a number of important structural reforms, particularly reforms relating to the pension system and labor markets that should help improve the sustainability -- the fiscal sustainability in the longer term, and strengthen the competitiveness of the economy.

So, what factors account for the unfavorable developments? Now, of course markets, appropriately, are forward looking. So, they acknowledge the progress that has been made in the past, but they are also concerned on a number of things. First of all, they are concerned about implementation, slippages, and delays that have taken -- that have been observed over the past six months.

Second, they worry about the so-called adjustment fatigue, political uncertainty, and social tensions that may make it difficult to effectively reduce further the deficit and control the debt dynamics in the long run. And concerns have been expressed, in particular, that an efficient public administration and the lack of political consensus on the adjustment program will hinder the attainment of fiscal targets and the implementation of the reform agenda over the long term. The implementation of the reform agenda is particularly important in order to boost economic growth, which is an important condition that will affect the sustainability of debt dynamics.

So, as a result, I think these concerns have led some to suggest that a vicious circle between lower than expected growth, than expected in the adjustment program, and higher than planned deficits is going to take hold and this will make the resolution of the crisis very difficult.

Now, I think some of these concerns are based on facts and they have to be addressed very carefully if further progress is going to be made and market tensions to ease, but I think also some of the concerns that have been expressed are based either on exaggerated assessment of the social and political -- the social situation in particular, or certain misperceptions of reality. But before coming to this point, let me say that over the past two months there have been two factors that have actually contributed to increase the market pressures. The first has been the debate on the desirability, necessity, or inevitability of restructuring and second, the speculation about what I would call the absurd and purely hypothetical scenario of Greece abandoning the euro area.

Let me make a few remarks about these issues. By the way, if you look very carefully at the evolution of bond yield spreads and CDS premium, you can see how particular events, debates, discussions, have played quite an important role, other things equal, understandably in enhancing uncertainty, fueling adverse expectations, and effecting market conditions.

Now, the option of Greece of exiting the euro area I think has already been dismissed as an absurdity by all responsible authorities, both in the European Union and in Greece. It is not legally feasible and I think it's self evident, and you said it yourself, that if one assesses very carefully the implications of this hypothetical scenario, you come to the conclusion that it would have serious adverse consequences, both for Greece as well as for the European Monetary Union.

It's therefore a non-option. Theoretical exercises and discussions that have taken place during the period of crisis merely contribute to increasing uncertainty and increasing public confusion, and I think this is not particularly helpful.

Now, the debate on debt restructuring has been extensive and intensive over the past few weeks. Now, the proponents of debt restructuring advance arguments that seemingly can help -- the debt restructuring can seemingly help address the countries debt burden and facilitate the fiscal adjustment process. Some consider it as desirable and necessary and in order to relieve the country's debt burden and address the medium-term funding changes -- challenges. Others consider it as inevitable given the size of the public debt and the perceived uncertainty about the sustainability.

Now, what I believe is that these arguments fail to take into account -- and I think this may explain also the ECB position -- I'm expressing my view, but it's not very different -- that the participation of Greece or any country in the monetary union and in the case of Greece also the composition of its debt by holder, imply that debt restructuring which entails haircut losses for the investors, for the holders of government securities, will have very serious adverse effects, adverse consequences, for the Greek banking system and the Greek economy and should also be avoided for many other reasons. And an important reason is the systemic implications of such a restructuring that the consequences it will help for market conditions and debt dynamics for other countries under pressure.

So, overall, I think debt restructuring is undesirable both for Greece and for the euro area as it will entail real costs and potential risks that are far greater than any perceived financial benefits. Perhaps during the discussion I can elaborate a little bit more because you advanced a number of interesting arguments and one would like to discuss them more, but I wanted to take the opportunity to say a couple more things if I can.

MR. VAÏSSE: Just one minute.

MR. PAPADEMOS: Okay. Then on the Greek case. I will skip over why restructuring is a necessary although it is undesirable, and let me say first of all on the Greek case that I believe that if the adjustment program, including the implementation of a new very ambitious privatization program that can help address directly the debt problem, if it's implemented fully, effectively, and consistently over time, and if also over the coming months there is a reduced uncertainty concerning the political support of this program over the long term, something which is quite difficult as recent events have shown, then this will play a very important roll in progressively improving market conditions because it will minimize -- it will actually reassure markets about the commitment and the capacity of the authorities and the Greek people to achieve the fiscal objectives and the structural reforms which are necessary to improve the country's competitiveness.

If you allow me 30 seconds just to mention the topic, and I'll come back to this later. Having said that, I think it has to be agreed -- we have to be realistic -- that it may not be possible that the improvement in the market conditions will be rapid enough in order to make feasible the funding of the borrowing requirements of the Greek state over the medium term, that is in 2012 and 2013, at a reasonable cost.

So, certain actions and arrangements could contribute toward facilitating this and what I have in mind, which I will elaborate later on, is two things, first that the scope of activities of the EFSF and the new to be established EFSM, can be expanded as to allow interventions in the secondary market in order to improve market functioning, not to have debt buy backs because these markets are illiquid and dysfunctional during a period of crisis and allowing this intervention can really facilitate both the adjustment process of the countries and also speed up the resolution of the crisis. And the other point has to do with the provision, which is at present incorporated in the framework of the EFSM, related to the private sector involvement in the case of potential insolvency. I believe that this provision is appropriate in principle, and it’s an important way in order to minimize the moral hazard in the longer term, but we have to think very carefully how the introduction of this provision during the period of crisis and increased uncertainty, whether it will have undesirable and unintended, I believe, consequences for market conditions and can hinder the resolution of the problem.

So, I’m not against having it, but we have to think how to have it in a way that minimizes unintended consequences in the short term. Thank you.

MR. VIASSE: Thanks, Lucas. Without further ado, I’ll turn to my American colleagues and ask Don first for his view on the European situation.

MR. KOHN: Thank you, Justin, and thank you for the opportunity to participate in this panel. It’s funny, the state of the Eurozone, I kind of -- there are different perspectives here. If I look from 30,000 feet -- if I can get away from the ash cloud anyhow and look from 30,000 feet, the Eurozone macro economy is not doing that badly, right? It’s growing; it’s expanding, pushed forward by the France and Germany, in particular. They have an inflation problem but it’s not significantly different from a lot of other inflation problems being faced today, but of course when you look down -- when you drop below the ash cloud and look down closer, there are all these tensions that we’ve been talking about within the euro area, and if they’re not resolved in a prompt and thorough way, they could undermine economic progress, not only in Europe, but here as well.

So, I think the U.S., we can’t kid ourselves in the U.S. We have a very strong interest in how Europe resolves these issues. Our economies are tightly integrated. We saw over 2007 and ’08 and ’09 how closely integrated our financial markets are. We have banks operating both in the U.S. and in Europe, both U.S. banks and European banks. We saw the effects of the dollar shortage and demand for dollars in Europe on U.S. markets in the early part of the crisis. U.S. money market funds have lent a lot of money to European banks. Our economies and financial markets are very closely integrated and we have every interest in helping you guys work this problem out.

I think there are also lessons from Europe for the United States, lessons in living beyond our means, both on a fiscal level -- certainly the U.S. has been doing that and is projected to continue to do that for some time -- and the lesson I think we can draw from Europe is that you can go for a long time without market discipline. And those markets can turn very, very quickly and you're forced into situations that force you to take actions that are not in your long-run best interests because they're forced by the markets. They happen very suddenly. They're very, very costly. But I think there's also lessons, not only on the fiscal side, but on the broader national side. The current account deficit that the U.S. ran for so long, there also market sentiment can turn. In order to borrow the money to run the current account deficit, you have to have the confidence of the markets and the other countries, and I think there's -- we need to pay careful attention to how we're emerging from the recession. We need to be much less dependent on foreign borrowing. We need to have a much smaller current account deficit.

Having said that, the U.S. ahs a substantial interest in what happens in Europe. I think we're limited in what we can do directly to help. The Federal Reserve has made swap agreements available to Europeans to help with dollar funding if that becomes a problem. Certainly, the U.S. has and should support sensible solutions that involve international organizations like the IMF so that the U.S. is contributing through its participation in international organizations, but there's, I think, not much else -- maybe Ted has some ideas -- of what we can do to help you guys through this crisis.

Looking at this from the U.S. perspective and having lived through the financial crisis over here, I think what's particularly striking -- and this has been emphasized by the previously two panelists -- are the political difficulties one sees in Europe greatly complicates the crisis management and longer-term reforms. In the U.S., crisis management was closely coordinated among the central bank and the Treasury. There was broad agreement on the diagnosis, the approach, and the forcefulness of that approach, the need to come in with a lot of support and action to stabilize the situation.

There was also broad diagnosis on what needed to be done to reform the situation in the banking -- U.S. banking and financial markets to create a more stable environment going forward. It wasn't always easy to sell this to the public. It took, I think, joint visits by both Paulson and Bernanke and Geithner and Bernanke, to do this, but it's striking that it was this coordinated action by the fiscal and the monetary authorities that stabilized the situation and that's obviously missing in Europe today, the lack of a large fiscal authority in the Eurozone is hurting both crisis management and the approach to longer-term corrections.

I think in this environment the ECB strikes me as probably the only institution that can take a kind of a zone wide perspective and then act forcefully -- has the tools to act forcefully on that perspective, and they've done that. There's a lot to applaud in what the ECB has done, but they are naturally reluctant, and I'm completely sympathetic with this, to be a sort of a stealth fiscal redistribution system by taking losses on what they have in their portfolio. And they are very, very conscious, as Lucas emphasized, of the contagion risk of having problems in one area spill over to the other areas. Once you start knocking over those dominos it's very hard to know where they're going to hold.

In this kind of environment we've had very strong liquidity support and not very strong sovereignty capital support for solving the problems and the tension between sovereignty and the individual countries, and the need for forceful coordinated actions with a fiscal character is evident, the sort of coordinated approach that Beatrice was talking about. And they've been trying to get by, by just doing enough and that obviously has reached its limits. It's not happening. They need a much more forceful approach.

I never liked that bicycle analogy that people use for the European Union, you have to keep riding forward or the thing falls over. But I think we're kind of there now, actually, that monetary union, euro area is at a very critical point in its history and there needs to be much more the sort of coordinated actions that Beatrice and Lucas were talking about in the euro area, not only from the ECB, but from fiscal authorities.

And I would say that thinking by analogy to how we handled the banking crisis, more forceful kinds of things than are currently, at least, publicly in train.

In the banking crisis we had to stabilize the system by providing liquidity and providing capital while making the intermediate -- the medium- and longer-term reforms to stabilize the system over the longer run. To me, this implies that we need -- Europe needs the continued liquidity support, they need to stabilize the situation through liquidity support. The ECB has got to be part of this thing as well as EFSM. The contagion, one important channel for contagion, is the banking system in Europe, so I think, very critical to strengthen the banking system, to force those banks to raise capital, either from the governments, or better, from the markets. So, I think a substantial strengthening of the banking -- the outcome of the stress test that we'll get later in June is a very critical point here.

Concerns about the banking system are constraining the authorities as they look at what to do about sovereign debt, and a very high priority should be to strengthen the banking system to raise capital in that banking system much more than it is now.

And I think the other point is there's a lot of emphasis on what the Greece and the other weaker countries need to do but also a lot of concern about the political will and the patience of the people of these countries to take the needed reforms. And those reforms certainly are needed, both in the fiscal area and on the competitiveness side as well. Even if the government wasn't borrowing, countries with current account deficits, the private sector, would need to be borrowing. They need to become more competitive. In an environment in which you don't and can't devalue your currency relative to your major trading partners, this can be a very difficult internal process of discipline on wages and prices within the country. It could take a long time. To me this implies -- but it's absolutely necessary, but this implies not only all this emphasis on pain in the -- and reforms in the periphery countries, in the countries that are troubled, but it also implies that the other countries of Europe are going to have to step forward and support those countries as they undertake those reforms. Otherwise the reforms and the increase in competitiveness would be so difficult and so painful, it won't be carried out.

So, more emphasis, on my mind, on the coordinated approach Beatrice was taking, was talking about, will have to include help from the center, from the stronger countries as well as sacrifice by the others.

MR. VAÏSSE: Thanks very much, Don. Ted?

MR. TRUMAN: Well, it's a pleasure to be here. Yes, I worked at both the Federal Reserve and the Treasury and it used to be that I used to say it was easier to be -- respectable to be a former central banker, but it so happens that the balance has switched a little bit, Don, over the last two or three years. It's not quite as respectable to be a former central banker as a former Treasury official.

I was --

MR. KOHN: We'll talk about this later, Ted.

MR. TRUMAN: Well, okay. I was very glad that Don mentioned the lessons for the

United States because I don't want my comments to say that we're perfect, by the way, here. I don't think there's any sense in that regard.

On the question -- issue of the years to come, I'm going to start out my remarks by saying I participated in a panel at the IMF in March of 1998 on the EMU and the International Monetary System, so we've been going for 14 years, and I noted that the EMU would create a stateless currency, which was pretty unique. Europe would be living in a halfway house where economic decision-making would be done in an uncertain manner. And the effects of that decision-making would be important for the continued stability and prosperity of the global economy.

Certainly the single currency of the EU is a unique experience. One can say it's like the Gold Standard, but I think it actually is very much not like the Gold Standard.

And as far as the halfway house is concerned, my comments at the time in 1997 are relatively mild. You have these two strands, a debate, it seems to me. One was between the -- which was largely European -- between what I think has been called the economists school and the monetarists school. And the economist's school said, economic integration comes first and then you have central decision-making, and the monetarist school said, we build the Central Bank and everything falls back into place, and smooth integration follows from the institution building.

Then you have the second debate, which involved those who were worried about whether Europe was an optimum currency area. This was largely a U.S. debate, but as we just heard it still resonates in Europe, and worrying about so-called asymmetric shocks. Now, in the first strand, my view is that the politics of -- and I think this is broadly consistent with what we've heard -- the politics of European institution-building was ahead and now is behind the economics of convergence with unfortunate results. The establishment of the Eurozone with a single currency was not enough. It facilitated the emergence of intra-European, Eurozone imbalances, and policies and the political narrative have not kept up.

For example, in Germany, the advent of the euro was good for business, better than expected, as my colleagues across the street have written in the *Financial Times* this morning. This is a coincidence. Germany's real effective exchange rate is now 10 percent below where it was in December 1998. Between 2005 and 2010, its current account surplus, scaled by GDP, was 6 percent of GDP, more than 60 percent, larger than the average between ’85 and ’90, before German unification when it was a big problem for the world economy, the German surplus.

However, the German political elite -- this is where the political narrative comes in -- failed to explain to the general public -- this is not just Germany, but I’m picking on Germany. I’m glad you’re from Switzerland so I can pick on you -- Germany with some impunity -- failed to explain to the general public that these benefits might not be permanent and that they might involve a cost that might have to be paid later.

And on the optimum currency area and asymmetric shocks, what we have learned is the asymmetric shock, which economists actually had trouble generating examples of, turned out to be largely internal in nature. Europe participated in a global credit boom, it benefitted the exporters in Germany, the consumers increased, the homebuyers in Ireland and elsewhere, and the credit boom facilitated the build up imbalances that have now -- in the Eurozone itself, which is now bust.

So, the halfway house has not served the Eurozone well.

Now for the rest of the world, for the last 18 months, non Eurozone countries have been adversely affected by the European/Eurozone crisis. The euro has been weaker than otherwise. European growth, on average, has been slower, notwithstanding the fact that it’s been better maybe than expected, slower. Financial volatility has been higher, and countries outside of Europe have shouldered some of the financial costs of dealing with the crisis.

I don’t want to be misunderstood. The economic case for IMF and Federal Reserve -- I wrote this before maybe knowing that Don was there -- to assist Europe in general and the Eurozone in particular is very strong.

At the same time the -- and I would have to use this word -- smugness from the European economic policy elites blinded them to the emerging crisis and that smugness has also exacerbated the normal political difficulties associated with selling such assistance to Europe to a skeptical public in the United States and their representatives in Congress. I think this applies to the rest of the world as well.

There are economic, financial and political limits to the amount and nature of outside support provided to Europe, notwithstanding what Don said. Taxpayers in Europe are skeptical about the wisdom of continuing on the current plan trajectory, but most European -- Eurozone politicians and policymakers appear to be determined to press ahead.

On the other hand, in the United States, Asia, Latin America, and Africa, taxpayers and their political representatives understandably are more skeptical because they are less likely to be directly affected by the fallout from a true Plan B, which would involve a significant write-down of sovereign debts of Greece and potentially of other countries if and when that becomes necessary.

Taxpayers and politicians outside of Europe are also likely to become increasingly less tolerant of the European halfway house. Either Europe should move forward towards greater economic and financial and political union, and as these recent moves, I think, as you said, Justin, are less than convincing and are still on paper, by the way, maybe why they're less convincing, they've been there before -- or Europe should move back towards a closer form of economic and financial confederation including the reintroduction of exchange rates ability.

Now, let me be clear. I worked with -- under Bob Triffin, right. I favor the first option. But those are the options.

More immediately, however, the leadership of the International Monetary Fund should not be held hostage to the parochial interests of Europe and the Eurozone. The next managing director of the Fund must represent the system as a whole. European argues that she or he should come from Europe because half of the IMF's percent of the exposure is to Europe. Quite frankly, as many people have written, including myself, that argument does not pass the smell test.

The interests of the international monetary system require that decisions about the terms and scale of support for economic and financial programs in the crisis countries of the Eurozone not be made in Berlin, Brussels, Frankfurt, Helsinki, or Paris. In an open selection process for the new managing director, any candidate from Europe must receive the broad support of other members of the Fund. Those members must be convinced that the new leader of the IMF will analyze the pros and cons of moving to Plan B from the perspective of the system as a whole. Thank you.

MR. VAÏSSE: Thanks, Ted. You know, I'd like to get back to Beatrice and ask her about this halfway house. You know, a year ago, when we did this panel on the Eurozone crisis, people were, you know, already startled that Europe had been able to put that package together to rescue Greece, et cetera. And since then we had the comprehensive solution, and I won't repeat all the things -- I mean, many of the things are already in place, like the stress tests are going on right now and we'll have the results in a few weeks. The European parliament in a few weeks from now will approve the comprehensive solution, which is a leap forward in terms of integration and --

MR. TRUMAN: On paper.

MR. VAÏSSE: So, why on paper only?

MR. TRUMAN: We saw the stability growth pack, right, the first time it was confronted it was ducked, right, and weakened. So, there's no -- there is good reason for the markets to be distrustful of paper documents.

MR. VAÏSSE: Precisely. So, what's your reaction on this and how do you assess the comprehensive solution and the halfway house? Are we still at a halfway house in terms of currency zone or currency unit or have we moved forward, if perhaps insufficiently? And how do you see the next steps, towards more federalism or to use that word, what are the necessary steps taken, and do you agree with Ted's position?

MS. WEDER DI MAURO: Sorry, no, I do not agree with Ted's position on most things, but on some I do.

I would say, yes, first on what I agree. We are not there yet, but I would not agree with basically just saying everything is just on paper.

The EFSF is not on paper. It's there. It is workable, it is functional, it is actually already lending to Portugal and Ireland. The ESM is decided. You know, its fine-tuning is still on the way but the ESM is going to be a European monetary fund and the Europeans have chosen to still have the International Monetary Fund in there, well, for several reasons. I don't think the main one is to have some co-financing. I think the main one is actually that the IMF can play a certain role of independent third party, which actually helps this coordination problem.

The Europeans have a lot of experience with this coordination problem, and in fact, you know, this has led to several solutions. I mean, many of the policies in Europe are already, to some extent, delegated to a European level. This is something that is just not in existence in any other place or any other area of the world, and nobody else has experience with this. This is why it's very hard to understand that European decision -- the European decision-making in general.

At the level of this new European monetary fund, for instance, what happens is governments set the rules for now having programs if it came again to be necessary, but they also at the same time said, okay, we want to have a very high level of control. So, in many of the stages you actually need unanimity. This of course leads automatically to a lot of bargaining and a lot of this common decision-making and need for discussions among governments.

This, in turn -- and that one I would agree with you that this leads to effect that in Europe we cannot expect in the short run the fiscal and the monetary authority to act together in the same forceful way as we've observed in the U.S. In fact, right now, one could argue that they are almost playing a game of chicken because the monetary authority has said, you know, enough is enough. We are not going to go further with the fiscal -- quasi-fiscal roles we have taken on, and this is, again, different from the U.S. I mean, the Fed never said, you know, this is our line in the sand. The ECB has stated to draw clear lines in the sand and staking its credibility on that too. That's quite a strong move.

It has, for instance, said that if the fiscal authorities go ahead with insisting on restructuring we will not accept -- and rating authority agencies -- not authorities yet -- go ahead with their threats to then put these bonds into default, selective default statutes, then the ECB would no longer accept them for refinancing. That, of course, you know, is a very, very strong -- it's, you know, what somebody called kind of the nuclear type of threat.

So, right now we have -- we do not have the two authorities acting in concert, but -- and this is part of the problem for getting to a real comprehensive solution, that was my initial speech. But let's also realize where we were one year ago. There was nothing in place whatsoever. Everybody was -- you know, had to -- everything had to be built from -- really from scratch. And this concerns both the crisis management institutions as well as the long run institutions which are meant to stabilize the system in the future, and now there is in fact an important interaction between what you would want to have in the long run and what this may imply for the short run. This is when we get to the question of, you know, what is the role of bail in in the future? In my view, somebody mentioned it, market discipline always -- at the moment -- always comes too late and too much. Too much, too late, because it's not market discipline. The markets cannot function under the circumstances as we have worldwide. There is no type of insolvency law or institution or something that simulates the losses that would happen when a country is actually insolvent. It's just not in existence. The SDRM was not accepted worldwide and Europe is actually trying to implement some type of SDRM for the long run. And that's right, that's a right solution because it is real reinforced market discipline in the long run.

But the question is, how this interacts with the short run, and that's where your concern was mainly that, you know, right now the countries that are in trouble now may actually have a problem if we are talking about bail in in the future, because then people will expect the bail in right now also.

So, I do agree with the fact that we are not there yet, but I completely disagree with the fact, you know, this is not going in the right direction overall. At the European level I really think the decisions that have been taken in only one year, the institutions that have been put in place in only one year, and they are not only in paper, I really want to address this, because it has required all this coordination and the coordination did work to put in place, for instance, an ESM. This is the way forward, it's not there yet, and why is Europe going to continuously keep building these institutions, because, you know, if you are serious, you can criticize. You can criticize a lot, but seriously, what is the alternative? You have to also think seriously about -- through the alternatives and come up with a better alternative. And I don't think just saying, you know, then you break up is an alternative. That's certainly not a good one.

MR. VAÏSSE: Lucas?

MR. PAPADEMOS: I want to comment on something concerning the future. I think the important steps that were taken at the European level over the past year do not only concern the establishment or relate to the establishment of the EFSF and the ESM, which are mechanisms for crisis management and crisis resolution. These are very important, of course, because this is the immediate objective, how to resolve the crisis, but I think what is very important for the future of the EMU are the decisions that have been taken to reinforce the economic policy framework in the euro area, both by reinforcing, by strengthening the stability and growth pact and also by broadening the framework to have better economic surveillance that would also focus on competitiveness developments and balance of payments developments.

What I think is very important is to ensure that in the future crises like this one will not be repeated. And why does this crisis occur? I think first of all -- in two sentences, really, because countries made very big policy mistakes, they pressured some of them, very responsible fiscal policies or inappropriate labor market policies that were not compatible with the single monetary policy of the ECB, and at the same time, markets did not exert sufficient discipline in the new EMU framework.

Now, at the same time -- so, one important cause of the crisis, and perhaps the most important one, had a national origin, but at the same time, the stability and growth pact, and more generally, the economic policy framework that was aiming at aligning fiscal policies toward sustainability and coordinate them in the direction so as to make them compatible with a monetary union, that framework simply failed. It turned out to be both ineffective in preventing crisis, in correcting mistakes, and also it was incomplete in that it ignored in any systematic way the development of other macroeconomic imbalances, the losses in competitiveness, which are large and persistent, and the associated current account imbalances.

I think the new framework, and also in the light of the very painful experience over the last few years, is going to make a big difference in order to strengthen the functioning of the EMU, even if there is no considerable progress in the direction of a political unit and federals.

MR. VAÏSSE: I have a question for Don. You know, as (inaudible) sometimes points out, the U.S. fundamentals are worse than the EU if you take the two zones generally. Standard and Poor's recently downgraded the outlook for the U.S. You could say that, yes, Europe as a monetary zone is a halfway house and political leadership is lacking, but here in the U.S. political leadership is also lacking as we've seen with the debates on the debt ceiling.

So, what exactly is the difference and why -- so, we were just talking of market discipline and the fact that basically lenders were lending to Greece up until December 2009 on par with Germany. So it's not market discipline. It was a blindness or just suddenly realized something, and now they seem to be treating the U.S. and Europe very differently. So, could you address the different -- Ted was saying earlier, you know, we're not perfect, et cetera. So, could you address the differences and point out why -- and then I'll ask the question to Ted, and then why is the U.S. treated differently than Europe.

MR. KOHN: So, I think, one difference is the components of overall relative total. So, I agree with you that the U.S. political system is not, so far, very good at coming to grips with our intermediate and longer-term problem. It might even not be very good with coming to grips with our immediate problems, the debt ceiling, in early August. We'll see. I think that will -- they'll work that out, but the tougher problems are the intermediate and long-term fiscal trajectory, which is not sustainable, very serious problem in the United States. And our political system has only actually begun the conversation about that late last year. It's encouraging the conversation has begun, it's -- the tone of the conversation, however, is not very encouraging, but at least they're talking about it.

So, I think -- I don't think people are making comparisons of U.S. and Europe and saying somehow the U.S. is better off, doing a better job than Europe in general. I think Europe has a different set of issues when the sovereign components are having problems. So, the U.S. debt is treated not any differently than German debt or French debt. It is treated differently than Greek debt and Portuguese debt and Irish debt, just as U.S. debt is treated differently than California debt and New York debt and that sort of thing.

So, the U.S. has its components that are having issues and are suffering in credit markets as a consequence, just as Europe is. I don't think one is being treated significantly different from the other.

MR. VAÏSSE: So, Ted, is one of the reasons for the difference, the absence of a transfer union in Europe -- Don was mentioning different states and some of them are in a dire situation, indeed, but we know they won't fail or they won't fail for long or for real, whereas in Europe, some countries have had to be rescued, really, and we've seen in the past for some cities or some states -- New York City in the '70s, obviously -- situations like this. So, is that one of the critical points of difference?

MR. TRUMAN: Well, it's an interesting -- look, Don and I see Europe, understandably, through U.S. eyes. In fact, I participated in an exercise run by the British about thinking about the European Monetary Union when they did their examination of joining and forced me to learn a lot more about U.S. monetary history than I knew before. I think the one advantage is we have one structure, so we actually have solved, as best you can, the coordination problem, and I think that's the point. We don't -- a simple example of that, we may have our political problems, but we've settled that actually you only need 60 percent of the Senate plus 50 percent of the House to get -- that's the vote, 60 percent of the Senate, 50 percent of the House, that is a small majority relative to -- well, it's a super majority, but small relative to European decision-making at this time, and that's a big advantage, right, that we have.

So, we have -- even though it's clumsy, right, it is well trod -- the paths are well trod, when we know how we go about doing these things, and it will be ugly, and we will get there. The issue of the states, I think, is more complicated, right? We don't actually have a -- we don't have a mechanism for bankruptcy in states. That's part of -- actually, we have rejected that in the U.S. system, and that's one of the reasons why maybe I'm skeptical about the CACs in the ESM because they're only discretionary. I think it'll never happen. So, it will be even just confusing, quite frankly, and I think the important issue -- one of the important differences and why I'm -- look, I'm in favor of moving forward and I understand you can't do a great leap forward even to the messiness of the United States -- I can put it that way -- is the politics. I think the decision-making in Europe, right, is way ahead of the domestic policy -- the politics, the people of Europe, right, whether it's in Greece or in Germany or in Finland or wherever, right, leaving aside the fact that you have this problem that you have 10 countries that are outside the Eurozone, which is a big problem too. So, Europe, what is Europe, right? Is it 17 or is it 10?

But the politics, it seems to me, and there is much less buy into the system and where the system is headed -- and of course I'm an economist so I can pontificate about politics but I don't know anything about it, but we're all economists, so we share that weakness -- but I think that's the real problem, right, that how the political narrative is being sold and is it bought. That's why I made my point about Germany. The German public doesn't believe that they're part of the problem in Greece, and they were.

MR. VAISEE: Precisely. One last question before we get to the room. To you, Lucas. Focusing more on public opinions, public opinions in the South, especially in Greece, will have to bear the brunt of the adjustment within Portugal, in Spain, right now, even though Spain has not had the major problems that Greece and Portugal have had. In Greece, obviously, and we've seen a demonstration, we've seen demonstrations in Spain, but also in Northern Europe where taxpayers are getting fed up with the impression that they are subsidizing southern countries. In Germany, this idea of transfer union, of having a sort of *Mezzogiorno* problem or sort of replicating the help that was given to East Germany after reunification, and doing it again but in a context which is not national, but Europeans, and where they feel less solidarity or less natural empathy for people they perceive as having mismanaged their economy. So, how do you think -- how worried are you that southern public opinions on the one hand and -- just to sort of character -- Ireland is in the north, of course -- but southern public opinions and then northern public opinions will bear the -- will support the continued necessity for adjustment?

MR. PAPADEMOS: Well, let me respond, first of all, by focusing on the public opinion in the countries under market pressure, Greece and others as well. In Greece, in particular, I have been impressed by the fact that over one year, with a few exceptions, most of the time surveys indicate that a large majority of the public ranging between 60 percent, sometimes to 70 percent, are either supporting or at least accepting, the adjustment program as something which is necessary to address, first of all, the fiscal imbalances, that everybody understands now could not persist longer, but also address persistent and longstanding structural weaknesses in the economy.

Second point; and I think I have a feeling that in other countries, although I'm not as well informed about the outcomes of service, the general, let's say, sentiment of the public is not likely to be different. Second point -- I will make two positive points and one more cautious point -- is that public demonstrations, although they have received a lot of attention, both in the newspapers and on the TV, they've been relatively contained, I would say actually, very contained, both in terms of size and intensity, considering the magnitude of the adjustment. Many demonstrations, including some of the more intense ones the last few months, did not involve more than 10- to 30,000 people in a city of 4.5 million. Of course, I'm not underemphasizing the importance of 10- or 30,000 people, and one cannot exclude that in such demonstrations certain extreme events can take place that can destabilize the social environment. But I think one has to see this in a certain perspective, that is, during a period when over a 3-year period the real GDP has contracted by 10 percent and the real disposable income of civil servants declined in 2010 by 20 percent. Twenty percent. I think this is something that is not, I think, understood. It's a fact. It's in all the reports that have been written. Within an environment involving such a huge adjustment, that the market reaction is like this, I think it's rather remarkable.

However, now, let me give a word of caution. The adjustment process is reaching a critical stage where the reductions in real incomes becomes more widespread from the public sector to the private sector. And what is critical for public opinion, as well as social cohesion, is whether they can see down the road the so-called light at the end of the tunnel, because it has always been argued that labor market practices, bad labor market -- inappropriate labor market practices, and irresponsible fiscal policies would have to be reversed, and this would be good, both for stability and for sustained growth.

Now, if the recovery does not come at the expected pace, then I think one can expect certain tensions. And in order, however, to address these tensions, I think it's especially important -- I wouldn't be -- the way, really, to address them in my view is to implement fully the program. Because part of the problems that are being encountered relate to the fact that certain aspects of the programs have not been fully implemented and these are the aspects that can help further support economic activity like the liberalization of markets, particularly the service sector, as well as the implementation of other reforms, which through increased competition and greater market adaptability, will help support growth.

Now, so, I'm on the whole, of course, cautious because the adjustment process, as I said, goes to a crucial phase, but on the whole I think we have to see that the public reaction has been -- I would say, encouraging, if I may use this word. Now, perhaps, Beatrice, you may say something about the public opinion in Germany and other --

MR. VAÏSSE: Is there going to be a rescue fatigue in Germany that you -- I mean, we saw populist movements in different places, Finland and elsewhere. In Germany, apart from the press, we've not seen a mass change in the political spectrum.

MS. WEDER DI MAURO: Well, you know, I think there is a latent potential in Germany for somebody to pick up this discourse and it has not happened. All the political parties so far have behaved very responsibly and nobody has gone for this populist course. But there are of course many people in Germany on the conservative side who think -- who basically go, oh, I told you so. We always knew it; one should never have done this, never with the -- there are so many prejudices about Greece, about -- I mean, Italy used to be actually the prime case where everybody -- even the textbooks I'm using, you know, they always have Germany and Italy as the two cases. They still do use Germany and Italy. I'm also Italian, by the way, so, you know, I can speak for Italy.

So, but Germany is learning very, very fast. It had to learn -- you have to imagine that nobody in the German parliament, in the German political system, not even the press, had or had any knowledge one year ago about what a stabilization program is. I mean, those were things that happened in emerging markets, not at home. Most of these people are not economists, they are lawyers, they are -- you know, they have liberal arts background. Now everybody is all of the sudden very much into macroeconomics. And actually last week it happened, you know, every evening when I got home I turned on the TV; there is a talk show about the euro every evening in Germany now. So lots of experts have actually emerged in a short time and you can imagine that these experts are, you know, a little bit all over the place.

So, the optimistic view is that this is a learning process. You know, in Latin America even the taxi drivers knew about hyperinflation at some stage because they've lived through it. So, this may be a learning process and in a way a fast track course in international macro that these people have to go through -- the peoples of Europe have to go through, and understanding, actually, how these things work, but there is, of course, also a more pessimistic side which is that this is also the breeding grounds for populism. Again, so far it has not happened and I am quite optimistic for Germany that it will not happen. This is partly to do because this kind of populistic approach is always also very much a nationalistic type -- it goes together, so these tend to be nationalist parties that go for this populism. And in Germany, for historical reasons, there is a very strong reluctance to be branded anything that has to do with nationalist.

So, it's not so much of a winning proposition for existing political party, but there is the possibility of something new emerging and the breeding ground is actually there. So, in that sense I do agree with what you said, Ted, about the political narrative. It's not only a political narrative; it's also the economic narrative. It's very hard -- you, as an economist, you go try and explain to people, even in the U.S., try and explain what is the benefit of having a dollar and not having several currencies. The economic narrative of the benefits of common currency and the research behind it, by the way, is -- it pales compared with the cost. I would guess about 5 percent of research is about benefits. And it's very hard also in Germany. You said, well, German is one of the winners. You know, even if you talk to German entrepreneurs who are exporting all over Europe and you tell them, well, you, of course, are one of the winners from the euro, then most of them will agree with you, but some will say, well, you know, we already did it before. We were already exporting, we were already successful before, and we're also exporting into countries that do not have the euro.

So, the whole narrative of the benefits is under developed.

MR. VAÏSSE: Thanks. Let's go to the room now. We have about 10 minutes and I suggest we take one round of three or four questions, so please identify yourself and make sure you ask a question. Thanks.

MR. RASHISH: Peter Rashish, U.S. Chamber of Commerce. To follow up on that particular issue of the understanding of the German public on the issue, can we be optimistic that when the stress test results come, out which are likely to show that a number of German banks hold not only bonds from the peripheral countries, but also have a lot of loans in the private sector in those countries -- can we hope that then it will be seen, you know, to borrow Christine Lagarde's phrase, it takes two to tango? These German banks made these loans out of free will to these countries and because of the recycling of all the surpluses which were fueled by the benefits from being in the Eurozone. I mean, can we hope that that will lead to a more balanced view of the causes of the crisis and thus, I think, a more reluctant -- less of a risk that that populism arises and more willingness to be part of the solution in Germany?

MR. VAÏSSE: Interesting. No other question? Yeah, there's one here.

MS. FRANKS: Sarah Franks, and I'm an independent researcher with Absolute Strategy Research. I guess our question is kind of similar, to carry on with the idea about Germany. I guess I'm most curious about, how does the German -- has Germany been given the wrong cost of capital? How is that going to play out? You know, we talk about the imbalances and the risk to that, what's the endgame there? I mean, you know, it seems like we're entering a time where current account imbalances are beginning to reopen. So, I'm just wondering what you guys sort of foresee for that over the next few years.

MR. VAÏSSE: In the back of the room -- sir, here, then in the back.

MR. DURANI: Yes, this is (inaudible) Durani. I'm a retired urban planning professor. I have a question for Dr. Papademos.

The questions that I have requesting your comment on those, is that really based on the difficulty in translating the broad view policy at the higher level, and the narrow view of a household itself. So, taking the Greek situation from two viewpoints, I would like your comment first on the general public viewpoint, for example, at the level of a small business in downtown Athens, and the unions, or in outlying villages or towns across the country, when the general population perception is that daily living has become very expensive because of the EU membership. And now they are being asked to bear even a greater burden of austerity.

The second question is, what is the government's response in convincing its own citizens that its policies will get them out of the hole that they dug themselves into? So, especially when tax evasion is so widespread among the Greek citizenship, that's what we hear.

On the lighter side, I want to ask Dr. Papademos that having intellectually wandered from physics to engineering -- electrical engineering -- and finally to the economics field, do you think that you are now firmly anchored into this economics field?

MR. VAÏSSE: Thanks for the question. Last two questions in the back.

MR. BACHMANN: Thanks. Thank you. Danny Bachmann, IHS Global Insight. If we went back to the 1980s, I have the feeling we could have had the same discussions substituting Latin America for Europe. If we were in the 1990s, the discussion would have sounded similar but we would have substituted Asia for Europe. So, does Europe have anything to learn from pervious sovereign financial crises, and when do we stop having the same discussions?

MR. VAÏSSE: There was one last question here, Dieter, and then we'll stop and ask the panelists to pick up the questions they want.

MR. DETKA: Thank you very much. Dieter Detka, Georgetown University. I would like to come back to the issue of debt restructuring. I think that's key because nobody likes to talk about it and it's difficult to accept that, that this might be the issue. There are nicer words now being used, not default and not restructuring, but re-profiling as the newest concept. But isn't it true that if we continue to treat this crisis as a liquidity issue, we somehow might end up in a Ponzi scheme of piling debt, new debt upon old debt, and the question is, of course, how long can this go? And then you might argue against populism and all of that, but it will come, it's unavoidable.

So, can you please take that issue up and maybe consider, you know, a little more seriously that the need for some sort of re-profiling -- I want to use the newest word here -- might be necessary in order to be convincing as an economic solution to Europe's crisis.

MR. VAÏSSE: Thanks, since our time is up, I suggest each panelist takes two minutes to pick the questions that either they have been asked or that they want to address.

Maybe we could start with you, Ted, and the reverse order.

MR. TRUMAN: Let me deal with the last two questions, since I have spent a lot of my career, for better, for worse, dealing with external financial crises, including Latin America and Asia.

The lessons, I think, are -- one lesson is -- which was actually echoed by Beatrice and Lucas -- is you have to move with force in terms of policy. When markets react, as (inaudible) said, policy has to overreact. And that lesson -- and the successful cases are ones where policy has gotten out in front and turned the markets around.

A second lesson is, if you're going to go the restructuring route, don't wait until you've no money left in the till. That includes no money left in the till for the international financial community to help the country who is going through the restructuring, so you don't want to drain -- absolutely drain public opinion -- I'm thinking about Argentina in 2001, a willingness to help the country meet the inevitable financing needs after you go through the restructuring.

But I don't think, at this point -- this should be clear -- that anything is inevitable. I think it's possible.

I will cite the example of Brazil in 2002. When the spreads on Brazil were at 24 percent, right, everybody insisted there would be a restructuring. By the way, the German government wanted a restructuring of Brazilian debt in 1998 too. Everybody thought there would be a restructuring of Brazilian debt, right, following the election of Lula. It didn't happen. So, the spreads on the market do not tell you that restructuring is inevitable.

Everybody writing papers, including across the street, my colleague Morris Goldstein, saying the debt dynamics does not add up. Right? It turned out because Brazil politically was able to put it together and increase the force of their economic policies that they were able to turn things around and it is now -- it may have its problems now, but it recently has been a pretty powerhouse, at least by Latin American standards.

MR. KOHN: I'll pick up that last point. I think not only is restructuring not inevitable, but before it happens, the contagion risks have to be much better contained than they are now. So, as I tried to stress in my opening remarks, I think the banks -- and this goes to the first question to some extent too -- the banks need -- the European banks need to be much stronger than they are. They need a lot more capital. They need to be forced to raise capital in the markets. In order to get it from the government with all the strings that come tied to that and not -- and to retain earnings, I think, increase in the capital banks will help tremendously to contain the potential contagion and would give the governments the option, perhaps, of re-profiling at some point. But right now I think it would be very dangerous.

The second point is the current account imbalances. I agree that if -- certainly if Greece and the other countries that are running deficits, or the United States, running current account deficits, are to run smaller current account deficits because they're more competitive in one way or another, then Germany will run a smaller current account surplus. So the Germans are going to have to think about how to generate domestic demand and not have such export, dependent export led growth, and that's got to be part of the formulation. It's very difficult when you're also constricting fiscal policy at the same time.

So, it's challenging but necessary. You can't have Greece, Ireland, Portugal, constantly in restraint, constantly constraining their domestic demand without something happening in Germany. And the fatigue on the periphery is going to -- is already -- I mean, Lucas may be right that a majority of the Greek population supports what's going on, but we saw problems in Spain, Portugal, and Ireland on the political side. And I wonder whether what's happening in Greece isn't a little bit like what's happening in the U.S. where the population sees the problem fiscally but doesn't like any of the specific suggestions about how to fix it.

MR. VAÏSSE: Lucas?

MR. PAPADEMOS: Well, let me also say a few words, first of all, on restructuring and then try to respond to the specific questions.

Now, the argument against restructuring -- first of all, you said piling up the debts and where will this end. Well, of course the idea here, and this is part of the adjustment program, is that when significant primary deficits are being established, then the debt will continue to go up for a while, it will start to steadily go down. So, the baseline scenario associated with implementation, not only of the Greek, but also of the Irish and the Portuguese program, imply that sustainability has been attained provided the appropriate policies are being effectively implemented.

Now, the other arguments against restructuring, on one hand they're the systemic and I think these are very important. One thing to keep in mind is that if there is a restructuring of debt in one country, even if it does not lead to, let's say, expectation that this will follow in another country under market pressure, the implications on market valuations, particularly if confidence is eroded, can be substantial, and the implications on bank balance sheets will be significant because the base is much bigger and is not limited only to their exposures to Greece, Ireland, or Portugal.

But let me add something more specific relating to the “potential benefits,” either for the country that may restructure its debt or for the creditors. And I think this very much relates, as I said very quickly during my remarks, on the composition of the debt by holder, and also very much related to the fact that the country is a member of the monetary union.

If we take the Greek example, just to give two numbers, one-third of the public debt is held by Greek financial institutions and Greek pension funds. Any restructuring entailing haircuts could not be absorbed by these institutions or the pension funds and would have to result into additional expenditure by the state in order to recapitalize them or support the pension funds. More than one-third of the debt is held by official holders, either the IMF or there are guarantees of the European governments or the ECB. Any restructuring that will imply any haircuts, will essentially entail a direct cost on governments and ultimately on taxpayers.

So, the cost will have to be directly absorbed by the taxpayers. And it seems to me this is both unacceptable in a monetary union of partners, that the actions of one will have implications for the taxpayers of the other, but also politically, if it happens, it’s going to be problematic.

So, what is left is the remaining part where one could conceive of potential benefits, although I don’t see how you can address only part of the debt in one way and not in the other, but if this happens, how will a country be able to access the markets again in a short period of time?

So, I’m just giving you a few arguments that it seems to me raise serious questions about the benefits of this exercise.

As far as the re-profiling, I would very much agree with what Don said, that under present conditions, the so-called concept of re-profiling, based on voluntary and market friendly arrangements is not a feasible one, and it’s not fundamentally different from a restructuring. Now, under certain conditions it may be able to implement such an idea, but I think at present is also not feasible and desirable.

MR. VAÏSSE: Thanks. Beatrice? You have the last word.

MR. PAPADEMOS: I will have to answer more bilaterally the questions for the other gentleman.

MR. VAISEE: Thanks.

MS. WEDER DI MAURO: Yeah, let me also start out with the restructuring question. I'm more sympathetic to restructuring earlier than later solution, although I have clearly said that it's very hard to be done in the right way because it would have to be truly comprehensive and taken into account the systemic effects.

Re-profiling, as a substitute, I think is not going to do much. You know, it started with the fact that, as you said it's only going to be affecting a small part -- an increasingly smaller part of the Greek debt, which is actually held abroad by financial institutions. You know, when people say, oh, it's the German banks that hold all this, it's not true. It's increasingly less true because they have also -- you know, any private institution that has been observing this crisis as it unfolds, has of course had its strategies of coping with it. And, you know, some of them have sold the Greek debt at secondary market prices, some of them have bought at secondary market prices hoping to eventually maybe profit from the fact there is going to be no restructuring.

So, my expectation, on your question in terms of the stress test is, that we're going to see actually quite little of these bonds still being held in the balance sheet and where they are still being held it's mainly in the public sector banks. So, those losses -- potential losses -- belong to the public sector anyway or they have been, in the case of the bad banks, previously private bank in Germany that was a very big one that was taken over by the public sector and they split off into a bad bank, that's where all these potentially toxic assets -- the old U.S. and other toxic assets and the new, possibly problematic ones, are being held.

So, the private sector, you know, immediate balance sheet impact, I think, is smaller than people think and it's becoming smaller all the time because more and more is being held by the public sector and it's being held by the ECB and, therefore, the problem becomes larger, which would be my argument as to why you have to do something earlier, rather than later, but other people will argue, well, that's why you can't do anything already now.

If you were to do something big, what could be a game changer? You said, Lucas, earlier that EFSF could be given an expanded role of the ESM in the future to also intervene in secondary markets. In my view, the lessons from Latin America is that it's not enough to lengthen maturities, to intervene in the markets, you do actually have to have some kind of debt exchange which involves really also a relief for the country in (inaudible) terms. And such a debt exchange could be organized to an ESM.

So in my view, that would be a game-changing solution, which could be implemented within the next year, and it would, of course, then also be -- at the same time have a solution for Greece and we also would have to say what you do with debt in Ireland and possibly in Portugal.

So, in terms of the stress tests, I really, again, as I already said so, the immediate direct impact of holdings of bonds in the peripheral countries, I don't think is the major issue and it's becoming smaller as we go along.

And finally the current account imbalance, I think here there is some misunderstanding. You know, people are talking about Germany two years ago. Last year the growth of Germany was mainly driven from the domestic economy and this year it is all, according to our projection, is going to be 70 to 80 percent. This is no longer an economy that is growing mostly as an export-led economy. That's not -- it's just not right.

So, this rebalancing, the internal rebalance, and of course the countries that are having to adjust very strongly internally now, they are not running the kind of deficits they used to run, so the current account imbalances inside the euro area, those are already adjusting, so the narrative and the discussion about Germany seems to have been lagging behind the fact that this is already happening.

MR. VAÏSSE: Good news at last. Well, please, join me in thanking the four panelists for a great session and we'll reconvene at 11:00 with Daniel Cohn-Bendit and Bob Kagan. Thanks.

(Recess)