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THE EUROZONE: NOW WHAT?
A CONVERSATION WITH LUCREZIA REICHLIN

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P R O C E E D I N G S

MR. WESSEL: I am David Wessel from the Hutchins Center on Fiscal and Monetary Policy here at Brookings and is an example of just how perfect our timing is. I can't think of a better moment to have someone who actually knows something about the European Central Bank and the European economy, especially someone who has such great foresight that her last day as a Research Director at the ECB was the day that Lehman Brothers failed. Lucrezia Reichlin really is a wonderful example of globalization. She was born in Italy, educated at NYU, has worked in Frankfurt for the ECB, taught in Brussels, and she's now Professor of Economics at the London Business School, a columnist for Italy's *Il Corriere della Serra*, a Director of Unicredit and at AGEAS Insurance Group, and she's involved in pretty much every European think tank I ever heard of. And on the side she has started a company called Now-Casting, a firm that specializes in real time economic data and near-term forecasting. But that's not the interesting part. I first heard of Lucrezia because I -- I don't know, I'm embarrassed to say this -- when I read a wonderful profile of her in the IMF Magazine which is a lot more interesting than you'd think. And I'm going to tell you a little bit about her non-economic background. Her Swiss great-great-grandparents moved to Southern Italy from Switzerland in the 19th century; her mother's family is of Jewish original and comes from Trieste which used to be part of the Austro-Hungarian Empire. Her mother, Luciana Castellina, was a prominent Italian communist intellectual, founder of the newspaper *Little Manifesto*, and later a member of the European Parliament, but she was expelled from the Italian Communist Party because of her criticism of the Soviet invasion of Czechoslovakia. Lucrezia's father, Alfredo Reichlin, was in the Italian resistance during the war, joined the Communist Party in '46 becoming one of its leaders and a shadow economy minister. Several years ago her mother published a book, a memoir of her youth based on her diary from 1943 to 1947 and Lucrezia wrote an introduction. I want to read an excerpt from that. She writes we are the children of the baby boom, of the opulent society, of mass education, of the legalization of divorce and abortion, of new opportunities available to women, but we have also experienced disappointment." She left Rome in the early '70s for Northern Italy, left Italy in 1978 for the United States, and unlike her parents she says she took refuge in numbers rather than ideology. "I studied economics and econometrics because I wanted to have a more specialized technical tool to discuss progress. It was probably a bit of reaction to my parents, but also in Italy at the time we started a lot of Marx in the new Cambridge school and I got a bit fed up with that so I decided to move to the United States and got interested in econometrics."

Lucrezia is going to talk for about half an hour. She has some slides which will be on our website and we'll post the audio on our website, and then we'll have time for some questions afterwards. I can't think of a more timely moment; we now know that the source of all financial instability turns out to be the Swiss National Bank. Who knows what surprises this afternoon will bring.

Lucrezia. (Applause)

MS. REICHLIN: Well, thank you for the introduction. I mean I didn't expect you to reveal the family secrets, (laughter), especially in the U.S. Okay, so I'm going to talk about the Euro Zone so if in fact, yes, as David said it's Switzerland the source of turbulence these days but, you know, maybe it's related.

So let me just give you a little bit of data about the recent past which will lead us easily on monetary policy and the choices faced by the ECB at this juncture. I think what has been happening since 2011 is quite amazing if you look at historical perspective. This is real GDP growth year-on-year. The U.S., the red line, and the Euro area, the blue line, so you see that at least since -- here I'm starting in the '80s but at least since the '70s recessions and recoveries have been very synchronized. The shaded areas are the MBI recessions and the recessions in Europe as dated by the CEPR which is a similar organization. Since 2011 we have something that has never happened before, so that the Euro Area went back into recession and while the U.S., although we may be disappointed about economic performance of the U.S., it is clearly in positive territory. So it's a recession which has to be explained with the differences in policies and it is quite a unique episode.

If you look at recent data, this is an index that I constructed which takes in consideration a bunch of different data in the economy, we can see that not only we had the recession in 2011, but also since 2014 it looks like we had a new slowdown just the moment in which the U.S. entered a much more convincing recovery. And this actually -- the second slow down, if you look at the number it affects not only the periphery of Europe but also Germany, the core of Europe. Now if you look at the nominal side of the economy it is also quite a dismal picture. Here is nominal GDP, year-on-year growth rate, HICB inflation, which is what the ECB is targeting, consumption, and monetary entry which is broad monetary aggregates which is something also that -- a variable that also the ECB pays some attention to. So you see they're quite flat. In fact the last reading of inflation is negative, so we have been heading toward deflation since 2011.

So there are three explanations of why the second recession which hit only Europe, why this new slowdown. One is monetary policy. The ECB has been late in recognizing the threat of deflation. The other one is fiscal policy. Fiscal policy has been procyclical in the Euro Area and the reason is that the treaty that binds the European countries together established some with some rules on debt and on deficit and so procyclical fiscal policy is motivated by the need of fiscal consolidation. So to take care of the debt we trust partly the legacy of the crisis. There is no doubt that fiscal policy has weighed on demand and in a way has been self defeating because if you look at the debt-to-GDP ratios in most countries you can see that it has been increasing and they definitely do not stabilize.

And then the third issue is that overhang. I mean of course this is related to point two, but we came out of the 2008 crisis with a huge amount of debt, public and private sector, and this of course continues to weigh on the economy because it induces the leveraging even in the private or public sector. I will argue that will be my point of the slides today that you cannot understand monetary policy without understanding this broader context; these three things are related.

So let me talk about monetary policy briefly. I claim that the ECB has been late in recognizing the track of deflation. We are actually now at what we call the zero lower bound, actually differently with the U.S. the zero lower bound depending on how you measure it but hit the Euro Area much later than in the U.S. So this is really something that has to do with the second recession, not the first. And then this liquidity operation that the ECB has implemented to provide balance with liquidity at long-term and at a fixed rate, the long-term refinancing operation, they are not really working that well in these more recent times. Now let me just briefly show you some charts. This funny chart here is the headline HICP, harmonize consumption index inflation, and the dotted lines are the forecast of the ECB at each different date. You can see that since 2011 the ECB staff forecast has been too optimistic with respect to inflation. So in order to understand the policy program that the ECB is facing now is that not only inflation has been declining, but actually it has been surprisingly -- there have been consistent surprise on the decline of inflation and the forecasts of the ECB have been biased in one direction.

Now for what concerns the lower bound, I mean on some calculation that you may possibly do, I mean you can try to see what would the interest be, the short-term interest rate on the left hand side if the ECB had behaved according to past regularities. That would be the black line and the red is what actually where the short-term interest rate has been. You can see that there is a significant difference. So this is what I call the zero lower bound. Not only that the interest rate is close to zero, but it should be elsewhere and somehow it does not. And on the right hand side you have the long-term interest rate. And then finally this is the balance sheet of the Euro system. You can see that after a peak that was reached in 2012 in this context which I've described the balance sheet has been shrinking rather than increasing. So this is the asset side of the balance sheet and in a way because of the type of liquidity policy that the ECB has been implementing the size of the balance sheet depends on when the banks give back the loans that have been obtained in this operation. And so they've been facing these endogenous decline in the size of the balance sheet.

Fiscal policy, I mean there are different ways in which you can look at the procyclicality of fiscal policy and how restrictive it has been. This is one way, for sure imperfect, but just give you the idea. So this is an index comparing three recessions, the 1980 recession, the 1991 recession, and the recent recession. It's an index on governed debt-to-GDP on the left, governed deficit over GDP on the right. I'm putting equal 200 the initial -- the beginning of the recession. Let's focus on the right panel here. You see that the 2008 crisis induced a large increase in the governed deficit with GDP ratio. You know, that's due to the denominator, the foreign output. But then since the third quarter of 2009 when the Euro Area entered a very feeble recovery, you know, there has been consolidation so that a dramatic decline of that ratio due to most countries running primary surpluses, in particular the countries of the periphery. And I think the shape of the green line with respect to the blue and the red line which is the historical behavior of the deficit-to-GDP ratio in recessions, that gives you an idea of the size of the negative fiscal shock or the positive fiscal shock; I don't know how you -- you know, but of the kind of procyclicality of fiscal policy.

Now on that I want to say basically two things, that on the left you have private debt of the financial sector, so just the financial sector over GDP, and on the right you have public debt. You can see the Euro Area, the red line in comparison with other big countries, Japan, the UK, U.S., and the developed markets in general, the black line. So that what -- the point of the left panel is to say that actually although the level of debt in the financial sector in Europe was smaller than the U.K. for sure and the U.S. -- the U.S. even not that much -- there has not been stabilization since the crisis. So the adjustment in the financial sector was delayed in Europe, and it was delayed to 2013 so we are now seeing something in the recent data, but we did not see the early deleverage that we have seen in the U.S., okay. So this is also part of the story of why economic performance has been so disappointing post crisis. You know, now we are starting the leveraging but more has to come, okay, so we are not at the end of this deleveraging cycle like in the U.S., okay. So this is something that still will weigh on the economy. On the right hand side you see the public debt and you can see that the trajectory is not very encouraging. Public debt-to-GDP ratio as a whole is still going up, so it's not stabilized. It's not particularly impressive if you look at the level and compare in general to the developed markets, the Euro Area is below this -- to Japan especially, however, you know, it is mainly this is a -- there is a redistribution problem, okay. Some of Germany has a debt of its GDP ratio which is around 60 percent, but you have a country like Italy which are like 135 and France is getting very close to 100 and also Spain which started from a low debt-to-GDP ratio is actually getting up in that -- you know, is definitely increasing the ratio.

Now you have in your slides the composition and the level for different countries, I'm not going to discuss that, but I mean I think it's quite interesting reading because you can see how there is a distribution problem between countries with some countries having a higher debt-to-GDP ratio than others, in particular the -- okay, these are the debt countries but let me see -- okay, so you have the core -- okay, these are the -- okay, so I miss the crucial slide which is -- that shows it -- I mean the big countries at risk which are Italy, Spain, and France. Now, so the three issues have to be analyzed jointly. Delay ECB action is explained, so why the ECB did not act before in terms of using tools that other central banks use like sovereign QE. Well, partly it is because they were concerned about moral hazard in a situation in which some of the sovereign may be considered insolvent or maybe could become insolvent within some scenarios for GDP or interest rate. Procyclical fiscal policy was also motivated by the same concern, moral hazard concern in the context of a monetary union without a common fiscal backing. And the debt overhang is a weight on the economy because it induces the leveraging and therefore monetary policy and fiscal policy which have procyclical effect.

So what is next? Okay. So I expect very little action on the fiscal front and on the debt overhang front, although I don't exclude that some changes that they change in the treaty will be discussed in the future. They are increasingly vocal -- they are increasing concern about how the treaty has been working and has not been working. But I think in the immediate future we should not expect much on the fiscal front; however, I mean, as it has been discussed extensively in the press we should expect some action from the ECB. Next week there is an important policy meeting and the market expects that the ECB for the first time will start purchases of sovereign bonds, so sovereign QE.

So let me now spend the next 10 minutes discussing about how we should understand QE in the context of the Euro Area. I mean I want to emphasize because we are in the U.S. that this is going to be a unique experiment, so sovereign purchases in an economy which has a federal institution regulating monetary policy, but no common fiscal backing. So the type of concerns and the policy discussion should be really I think different because of different institutional set-ups. So what is the general issue? So I think this is a unique experiment. There is a very complicit relation between fiscal and monetary aspect which have to do on concerns on how the distribution of risk and sort of how risk sharing will work in the Union given the fact that the budgetary responsibility is the decentralized.

These concerns are particularly strong from the creditor country side because of the leverage situation that I described. So you cannot really understand the current discussion without understanding the overall situation in terms of debt overhang. Now the concern which is partly justified I think is that if the ECB ends up buying a large proportion of government debt and assuming credit sovereign credit risk in its balance sheet there will be no threat anymore of that restructuring, so that because the debt will be held by the official sector and because of the lack debt restructuring this will eliminate market discipline. And in fact in a monetary union you want that possibility of restructuring to be there, okay, so to create some market discipline. And the fact though if this program is going to be large enough and end on its own that would effectively mean that the ECB is insuring the private sector from the sovereign risk. And this in fact is what the market wants the ECB to do and what the market sort of expects. Now the thing that I want to flag is that the treaty that we have in Europe has a paradox. So in principle -- and the ECB has to face this paradox. So the rationale for QE is a purely monetary policy one. The ECB is undershooting the target; the target is two percent or just below two percent. And of course now the attitudes that they have been using they have not been working so they have to move on purely monetary policy ground and do what other central banks have done. But the paradox is there, so on one hand the treaty has created rules to limit the redistribution effect on monetary policy amongst different countries, it has imposed all kinds of legal restrictions prohibiting monetary financing, it has a no bail out clause that exactly is there in order to prevent these cross country risk sharing of fiscal risk, but on the other hand when there is pressure on the debt front, the ECB is called into action as we have seen in 2012 and it's called into action to defend the common currency and to the survival of the Euro. And basically this has been done by preventing exit, of preventing default as we have seen in the case of Greece. Therefore knowing that the ECB will ultimately defend the Euro the market expected that the ECB will provide an implicit guarantee on all debt. Therefore from the discussion with the ECB as I understand it is to implement a program which should not be a pure monetary policy financing operation, should reassure the market, but at the same time you should be such that is not going to kill all market incentives, should not be perceived as a blank guarantee on public debt.

So what is the current policy discussion then? They could go for a large program, maybe around one trillion. These are the numbers that have been floating around. There is a question of what to buy, okay, either a single security, triple As, but this would be very divisive, or a bundle, a security composed of different weighted in some ways so they can go for market capitalization. That will be a very bold action buying a lot of Italian debt in that case, or they will most likely go to acquisition of securities which are average by GDP, which is the capital key of the ECB, and this will be sort of a very -- if they go that way either market cap or GDP weighting it will be a very bold action which will raise concerns of credit risk as I pointed out, but in order to face those concerns they could centralize the decisions on the purchases, but then decentralize the credit risk. So decentralize the credit risk in the balance sheet of the national central banks. Or otherwise they can go for a smaller program or just buy triple As, or just buy less purchases, but keep the risk sharing within the Euro system balance sheet as it is done now for their monetary policy operation.

So these are the trade-offs, size versus decentralization. On one hand the program must be large to convince the market, but the price that they may have to face in order not to be too divisive within the governing council is to say okay we will decentralize risk. And many intermediate options of course are on the table, you can think of all kind of possible different things. Now if they say decentralize which is now the current expectation from a lot of market participants that they will actually go for a large program and with decentralization of risk, there is a danger that the market will perceive these as a sort of the first step towards further decentralization and segmentation of financial markets which in turn will put some pressure on the periphery bonds. And especially if the economy doesn't pick up that will sort of further go in the direction of geographic segmentation of financial markets which has been one of the main stories of the crisis. Since the crisis we have seen that the flight to safety in the Euro Area associated with the crisis has taken the form of a home bias in different segments of the financial markets, but especially in the sovereign segment. We now are in a situation in which if you look at the government securities over total assets in financial institutions the domestic component has increased since the crisis while the non domestic other Euro Area countries has been declining. So before the crisis this was a very financially integrated market within the Euro Area and since the crisis it has been segmented. If you look at Italian banks as an example you can see these are the big Italian banks, different institutions, you can see the net sovereign exposure on (inaudible) one or the net -- this is in December 2013 and this is September 2014, so the sovereign exposure to their own sovereign has increased. The same is true for Spanish banks, but also for core banks. So the asset side of the balance sheet is becoming increasingly colored from the geographical point of view with a very strong home bias.

So this has created the correlation of risk between the sovereign and the credit risk. It has been called the diabolic loop between sovereign and credit risk. If the sovereign goes under the bank goes under, if the bank goes under the sovereign goes under. It's a huge problem and it's a problem that should not get worse in the case that QE is done with a decentralization of credit risk. That's the danger is that if they go that way the diabolic loop will become worse rather than better. So but something has to be done, okay, and so what I want to argue here that if QE would be designed optimally it should actually address both the monetary policy concern, okay, so being forceful from the monetary policy to address the inflation issue, but should also the same time address the second issue which is financial market fragmentation because otherwise it will be self-defeating. So there are two issues, one is fragmentation. So they would need to force the bank to diversify their geographical origin on this sovereign fixing of portfolio. And the second issue is that they should face the moral hazard of risk sharing problem. And here I want to put on the table a proposal which will say rather than decentralize, a proposal which is not at all in the cards, so it's purely, you know -- okay, so that maybe will be useful for future discussions, that rather than decentralize which is the way in which they will have to face the credit risk, they could create a safe asset from the senior tranche of composite security. So this is a proposal that I put together with my colleague at LSE, Luis Garicano and has a monetary policy aspect and says QE should go for diversified securities. We should not just buy triple As, but we should buy all the bonds weighted by GDP, the capital key, and you actually you could tranche this composite security and have a senior tranche and the junior tranche in six proportions. So this will be sort of a synthetic safe bond for the Euro Area. The ECB will announce it and I think there will be maybe hopefully the creation of a safe bond from the market. And this should be complemented to some regulatory changes or to some announcements that ECB will be -- or the single supervisory mechanism would announce that only the senior tranche of the security would be counted as risk free for the purposes of risk weighting and liquidity provision ratio calculations which would imply a change in the current treatment of sovereign bonds. As it is now Italian bonds have the same treatment as the German bonds. So this is kind of trying to be in between these two extremes, okay, full guarantee and just buy triple A or buy composite but decentralized risk.

Now the advantages would be the creation of a large safe asset which would be like the natural thing for the central bank to buy, so tranching should be seen as an alternative to decentralization and then there will be an incentive for banks to hold the diversified portfolios, so in a way to break this loop, this correlation of risk between sovereign and bank risk. So I think it's an interesting proposal. It's a proposal that I've discussed with ECB people and that may be become relevant at some point down the road, not immediately of course because it also requires some regularity and legal changes.

Okay, going back what is on the -- so if you put also the tranching you can see that there is a decision matrix that the ECB will have. If they go for buying a composite security they can just buy a security formed by each country that in its proportion or they can go for our proposal, or otherwise they can buy individual security without tranching or individual security with tranching and you can think of all the combination of these things. I mean I don't want to bore you with too many details, but I mean this I think is at least useful to get the idea of how complex the decision process is because unlike in the Fed it is not at all obvious what the ECB should buy and in what proportions. And what they end up doing will have an effect on the fiscal implication on monetary policy action which is at the core of the current discussion in Europe.

So in the interest of time I'm not going to go for the pros and cons of all different proposals, but I mean I just wanted to give you the flavor of what is the current discussion. Now what is the scenario? I think as I said I don't think our proposal will be considered, at least not in the short run. The preliminary ruling of the European Court that consider -- has -- that suggests that sovereign purchases are legal, they are not in violation with the treaty has been a very -- I mean at all expected, okay. I think it should be a good thing for Mario Draghi let's say and so I expect that the ECB will go for bank and not only triple A but purchases of diversified portfolio. I expect however most likely that if they want to be big they will go for some (inaudible) risk. So I think that this issue has to be seen with some attention, however this is not going to be the end of the story because I don't expect the deflationary threat is going to end anytime soon and I think that we doubt other policy tools, you know, more decisive fiscal action and maybe some overall agreement on how to deal with the debt overhang, the legacy that out of the crisis the Euro Area will be in stagnation for the future. Again I mean I don't expect a convincing recovery anytime soon so the ECB will be there with these purchases for a while and I think some of the issues that I flagged will continue to be relevant and how the central bank will act will have also an effect on the whole political economy of the Euro Area and the relation between creditor and debtor countries.

And with that I finish. Thank you very much. I hope I didn't speak too much.

MR. WESSEL: No, not at all. Well, thank you. I find that the best thing about having conversations about Europe is that no matter how gloomy you get about Washington Europe always looks worse. (Laughter) So I appreciate that. We could use a little of that here. I hope we can return the favor someday. Let me just ask a couple of questions before we turn to the audience. So I want to be clear on what the markets expect of the ECB and what you expect of the ECB. I think you suggested the markets might be expecting a bigger program?

MS. REICHLIN: Well, I mean I think -- what I expect for whatever it is worth is a big program and it is something maybe larger than 500 billion. I expect something relatively open-handed. I would expect a communication that would clarify that the size of the balance sheet is not a final target but is an operational target and so that whatever size or pace of purchases they will decide at the end is linked to some forecast of evolution of inflation or about that they will remain ready to adjust the purchases in relation to the new data. So I think this is what I expect. What the market expects, you know, especially since the Court ruling I think that the market -- you know, they were expecting -- I think they were also expecting something large of the order between -- maybe higher than 500 billion. I think on the risk sharing issues I've seen different opinions around. I still think they will go for decentralization, but maybe they will be bolder. I don't know. I mean for sure the Germans will oppose anyway so they will have Weidmann voting against. It is not clear what other countries like Finland and so on will do, but I don't know whether it is politically considerable that monetary policy in the Euro Area systematically ran, you know, with the negative German vote. So in that respect I think that the decentralization of risk maybe will be the price to pay.

MR. WESSEL: And decentralization of risk means that if Italy can't pay its debt that somehow that's on the Italian Central Bank?

MS. REICHLIN: That's right, the Italian Central Bank, and eventually on the Italian tax payers.

MR. WESSEL: All right. So --

MS. REICHLIN: Which is a bit cosmetic, right?

MR. WESSEL: Yeah, I think so. All right. Now how is this supposed to work to make the economy better? Long-term rates are already very low, Europe is a very bank-centric system. It seems to have already -- the expectation of QE seems to have already led to a depreciation of the Euro. Is there more to this or is it just kind of a psychological thing that the ECB says we will do whatever it takes?

MS. REICHLIN: You sound like Weidmann you know, Weidmann says, this would serve no purpose. And in fact the *Financial Times*, you probably have seen, you know, they have asked several market participants and the majority say that quantitative easing in the Euro Area will be ineffective. Now this is possibly the case. In fact if I talk to banks they also tell me that they will adjust their liability side, but for sure they're not going to start lending, you know, as the Fed or QE because there are lots of other -- there are concerns about capital and the non performing loans and so on. However, you have to think about what would happen if they didn't do it. And in a way just the announcement has already put down some pressure on the exchange rate and long-term interest rates. So in that respect, I mean they are a prisoner of their own communication. They have already announced it in a way so they will have to go for it, but it is dangerous. I mean I hope that other tools will be used to confront the stagnation because this over responsibility on the ECB shoulders is extremely dangerous.

MR. WESSEL: Right. But surely if you have a central bank with an inflation target that it's missing a lot, the central bank has some obligation to do everything it can think of, right?

MS. REICHLIN: Exactly.

MR. WESSEL: But you made an interesting point in your presentation which is -- let me make sure I get this right -- you think the fundamental problem that Europe faces is a debt overhang; that banks won't lend, the economy can't grow because there is so much of an overhang of debt and people expect higher taxes in the future or something, right, and you're suggesting that one of the downsides of QE is that it is seen as the ECB basically guaranteeing the sovereign; it takes the pressure off for restructuring.

MS. REICHLIN: Well, okay, so it's very -- so on one hand when you have debt overhang you want to use fiscal policy, but the fiscal policy we can't use it because of the treaty. So you can say, okay, given the institutional constraints this is (inaudible) support very strong QE, in fact what has been called (inaudible), right. I mean this is -- it can be thought as sort of a substitute for a fiscal transfer which in that condition -- I mean if you don't -- if you forget about moral hazard, about this political issues between creditors and debtors and so on maybe it would be the right thing to do. I mean ever more bold than what has been discussed, okay, so permanent purchases.

On the other hand because we have all these different fiscal jurisdictions there is a tendency in the Euro Area for countries not -- I mean there is a tendency to kill all market disciplines, okay, because once the market expects this kind of action from the point of view of the ECB it doesn't put any pressure on interest rates. So now Italian interest rates -- but not exactly, okay, but, you know, before the crisis the Greek interest rates on the sovereign debt were the same as the German interest rate on the debt. That was clearly mispriced from the market. Then there was this huge divergence during the debt crisis and now we are back in a risk-off situation in the expectation of the ECB. So I think this is too much, okay, so it's a noble killing. So we want to have monetary policy tool but we do not want to kill market incentive, but it's a fine line. So ideally we want to have some coordination within monetary fiscal policy and, you know, to have a more diversified package of demand management. I mean given the constraints a lot is on the shoulder of the ECB so they will have to be cautious, okay. And I don't think that the Union will survive if the ECB becomes the guarantor of all the debt countries. Politically would not survive.

MR. WESSEL: So what does this all look like five years from now?

MS. REICHLIN: Five years from now I think there will be an -- okay, the optimistic scenario, renegotiation of the treaty, you know. I think the ECB will be there with, you know, doing purchases and then there will be a renegotiation of the treaty which would allow for more active fiscal policy and maybe there will be some debt redemption of, you know, some kind of debt agreement. This was something that was discussed in 2012 also by -- there was a proposal by the German Council of Economic Advisors to have debt redemption for that part of the debt which is considered legacy debt in exchange for different rules for steady state which -- rules that would consider the possibility of restructuring within the Euro Area. I think that that's the right way to go. This proposal has been killed. So it's been -- now everybody thinks that QE will be a substitute for that. I think in my view it would be much better to have some debt restructuring, some fiscal policy, and some QE. And I hope that we will be gradually moving in that direction. I mean some of who are pushing for that direction. Of course we are not very popular. I mean the German economy is -- the central bank is in some -- now they have many different views and so that can -- we'll see if the stagnation can clear.

MR. WESSEL: That's the optimistic scenario, what's the pessimistic one?

MS. REICHLIN: Well, the pessimistic one is that there will be continued stagnation -- there are two pessimistic scenarios. One is stagnation possibility. Basically more fiscal consolidation, adjustment to real wages, and high youth unemployment, and somehow this will not create too much political troubles because the Europeans are very patient. And the third scenario which is the real pessimistic one is that the political crisis with anti Euro parties winning elections in countries like France, Spain, these are the riskier -- besides Greece, okay, which requires a separate discussion, but maybe down the line also Italy. And also the risk-off scenario, you know, okay, with the ECB doing QE, okay, some pressure on the peripheral bonds will be out, but if the discussion within the (inaudible) council becomes too complex I think the market may also start surprising in some created event. And then here I think that Italy is the dangerous country.

MR. WESSEL: I know that Don Kohn has to leave so I want to ask you one more question too but let me ask -- give Don a chance before he goes. There's a mic.

MR. KOHN: Thank you. Don Kohn, Brookings. It sounded like you were very much arguing that without some debt relief and debt mutualization nothing is going to work very well here. So I have really two questions. One is doesn't your proposal not have real debt mutualization and debt relief since you're trying to break off the safe tranches and leave all the rest of the risk in the market? So I don't see how your proposal fits in with that if the triple A tranches really are safe. That's a separate discussion I guess.

And the second thing would be it also sounds as if where the ECB sounds like it's going, which is a QE of size but leaving the risk distributed isn't really going to do very much because it won't break the diabolical loop. Is there anything that the ECB could do that doesn't involve debt mutualization that might be helpful from a monetary policy perspective?

MS. REICHLIN: Well, I mean the second question I will say that my proposal is better than decentralization, okay. So that the tranching is better than -- but I think that if we had debt redemption that would even be better. I said that I don't think that debt redemption is in the cards right now. Although things may change. For example Olli Rehn who is a conservative Vice President of the European Parliament and former Commissioner at the recent meeting of the European Parliament he said yeah, maybe we should go for debt redemption. So but of course this is very difficult. First of all you should not announce it if you go for that and also it has to really be something that put all the parties together right, because otherwise -- I think with Greece now we have to see how they will solve the Greece situation because, you know, how much debt redemption will be in the Greek situation because that could be actually -- would it already give some relevance of how to understand how the program will be dealt with for other countries. Of course now everybody says Greece is different, Greece is different, but after all Greece is not that different, okay, so that -- you know. If they clear the president that's --

MR. WESSEL: But Don thinks your proposal also eliminates the pressure for debt restructuring, right? Right?

MS. REICHLIN: Well, no. I mean the junior tranche will be -- all the sovereign --

MR. WESSEL: Market discipline there?

MS. REICHLIN: Yeah, yeah.

MR. WESSEL: So what's your forecast --

MS. REICHLIN: The question for my proposal is whether there will be enough demand for the junior tranche given the threat of restructure.

MR. WESSEL: I see. And so Greece, what's happening there, what's your scenario?

MS. REICHLIN: Okay. There I'm positive. I hope that I will not be proved to be wrong. I think that Tsipras has very crazy people in his own party, but I think he is not crazy. And actually he is -- some of the things he says are quite reasonable in my view. I mean given my communist past, you know, I'm now (laughter), you know, I am -- I can be suspected. But anyway, so it is likely that if he wins that he will govern with a coalition and therefore he will have to come to a compromise. So there the issue will be the uncertainty of the process, okay, that could create destabilizing issues. But I expect there will be a coalition with Centrist and I expect that there will be some negotiation and that some of the debt will be rescheduled. Although I also expect that the European authorities will be tough on the conditions of the first problem because otherwise they will lose completely credibility. So it will be complicated, but I don't expect Greece to exit. I don't think that anybody wants Greece to exit. I think there has been some noise in the press with *Der Spiegel* leaked some point of view from the Germans saying we don't care about Greece, they can go now, you know, we can't prevent contagion because we are in a different situation than in 2012. But then immediately after actually Merkel corrected the message and several other people have.

MR. WESSEL: So finally what would cause the Germans to change their mind about debt restructuring, about fiscal transfers, about whatever? I mean it seems to me the German economy does okay.

MS. REICHLIN: Not great.

MR. WESSEL: Not great, but Merkel seems very popular despite it seems to be a less than courageous leadership. It seems to me the only thing -- the German businessmen I talk to say well we're just investing elsewhere so we're voting with our money. The only thing that strikes me is that it must be a little scary to be in

Germany, to have been committed to the Euro and think that if you don't like (inaudible) you might get (inaudible), and you might get a reaction in Spain and suddenly you have a much different political climate in Europe and the terror in Paris can't make him feel any more comfortable. But I'm looking at this from Washington. Is that something that the Germans worry about or do they think they're immune to that?

MS. REICHLIN: Well, the Germans are worried. Now they have an anti Euro political party which is growing.

MR. WESSEL: Of their own, yeah.

MS. REICHLIN: Of their own. So and I think that this is also explains why Merkel is trying to be in between. I think that it is very difficult. I mean I agree. I think that the Germans have to be understood in the sense that some of the things they are saying -- I mean if you look at the amount of corruption in Italy, in Greece, and if you take for example in the Italian case, my country, it's a rich country, a country which is rich in assets, but it has not been growing for a long time and there is a huge amount of tax evasion and so on. To ask the Germans to take care of our debt is quite embarrassing. And so there is mutual suspicions and which is justified from both parts and so I don't have an answer for you. I think that so far the majority of the European cities want to stay in the Euro, but this is changing very fast. And I think that the French episode is a wake-up call which is linked to the issue of youth unemployment which is becoming -- I think in the U.S. 50 percent of youth unemployment which are the figures that we have in some of these countries will be intolerable politically, okay. And so it's quite surprising that we haven't seen a revolution in Europe. But things may deteriorate further down the line unless something is done.

Now for example Juncker has now designed an investment package so that -- you know, increasingly people are talking about pro growth policy beyond monetary policy. So far it's very underwhelming but maybe more will be done.

MR. WESSEL: It strikes me it's always just enough to get us to the next summit without a revolution.

MS. REICHLIN: That's right.

MR. WESSEL: I'm sure there are some questions. The gentleman here in the front. And tell us who you are so we can --

MR. BLEDOWSKI: Kris Bledowski from Manufacturers Alliance for Productivity and Innovation. Fiscal policy is not possible because of the treaty; that's what you said. Two weeks ago at the American Economic Association Martin Feldstein from Harvard made the following proposal, why not make a revenue mutual fiscal adjustment milking out different elasticities of supply with respect to different tax types. And possibly he may have thought of also multipliers on the expenditure side, but I think he meant the tax side. That would not infringe upon the treaty but nonetheless would give us a net gain on the output side. He said do not centralize any of this. When I probed him about this he said keep it totally decentralized even if one or two countries goes ahead with it and gives an example and it works, it could spill into the rest of the Eurozone. Is this something that you think some countries might consider? For example Italy I think would be a prime candidate and some of the others. Is this either discussed or you think it makes sense?

MS. REICHLIN: Well, actually funny enough he just send it to me, okay, because it's very keen for people to write about it and so on. So I haven't really looked at the details, but I understand that he would imply an increase in corporate tax which would be very improper I think in Italy for sure where -- but I mean maybe there is some room to work on the -- I mean I think -- I mean I haven't really looked at the proposals but definitely something to consider. There would be maybe credibility issues of, you know, (inaudible) and equivalent type of considerations, but maybe -- I mean the thing that struck me is that he would imply an increase in corporate tax which is not something that is going to be very popular right now. But, you know, I'm not --

MR. BRYANT: Ralph Bryant here at Brookings. It would be very interesting to hear you say a little bit more in detail about the ECB QE with the decentralization of credit risk. Just to take Italy as an example, if the ECB buys large amount of --

MR. WESSEL: Hold the mic closer.

MR. BRYANT: -- Italian bonds, what would happen in detail to make the government in Italy take that -- would there be new entries on the balance sheets at the Banca D'Italia and the ECB or would some kind of a written statement be made? Are there legal constraints either in Italy? Exactly how would this decentralization of risk occur?

MS. REICHLIN: Well, I think that the National Central Bank will have to provision for this credit risk. So the question is how much reserve do they have and I think that so far so good. I mean I think that -- I mean there is buffer, okay, in the National Central Bank to be used for that purpose. The question if there is a credit event, I mean if Italy go bust, okay, what will happen, you know. At that point the Banca D'Italia will have to be recapitalized by its own treasury. So taxes will have to be raised and then the question is whether this is going to be feasible or not and maybe at the end the ECB will have to act as lender of last resort anyway so that -- it's a very strange program, no, because the Banca D'Italia cannot monetize because only the ECB can.

MR. WESSEL: I liked your earlier description better, "cosmetic".

The gentleman in the front here.

MR. BIRNBAUM: I'm Norman Birnbaum from Georgetown. I noticed that everybody regrets the rigidity of the German situation, but the obvious solution but the obvious solution to it is one people would regret even more, namely a less fleshed green coalition. But I would like to ask our speaker if she would care to comment a bit on the extremely complex and to many Americans utterly untransparent domestic situation in Italy at the moment?

MS. REICHLIN: You know, not only untransparent for Americans but also for Italians. (Laughter) Well, I mean the domestic situation in Italy -- well, it's actually better than it used to be. Now we have relatively popular president of Concilia who has however a divided party so that I think the opposition in Italy is very fragmented now. And so there is expectation that democratic party which is the majority party, if there is going to be an election they are going to win with a wide margin. However, the party itself is very divided and so far Renzi controls it, but there is kind of a vocal minority. This slows down the process of reform, but so far they have been able for example to pass the labor reform which is quite a radical reform. The process is not totally over through Parliament but if will come out of the Parliament similar to what has been proposed that will change the labor market quite substantially. The question is whether this is going to be a game changer for the Italian economy. There I have some doubts, but in any way politically it is important because it will s how within the Euro Area framework that Italy actually can delivery reform, okay, which is something that -- so of course if the situation of negative growth persists with persistent unemployment I expect that the more radical party, anti Euro, will gain some strength. But paradoxically they are weaker than in countries like Spain where actually the economy is doing much better.

MR. WESSEL: And a lot turn on Italy, right? I mean it's the big indebted country that isn't growing.

MS. REICHLIN: Yeah. Italy is the worst case because it is not growing.

Actually it has been shrinking. And it came into the crisis after 15 years of very low growth. So Spain, you know, before the 2008 crisis and the first 10 years of the Euro had a rate of growth which averaged 3.5-4.0 percent, Italy grow at 1 percent. So Italy is the sick man of Europe, or sick woman of Europe and I don't think that this kind of stories can be changed through labor reform or through three cosmetic things. I mean it's a deep rooted issue, very low productivity, small size of firms, okay, under scale, so even export has not done very well in Europe in Italy which traditionally is an export led country, completely underdeveloped south with big issues of, you know, kind of inefficient and corrupted public sector, and so on and so forth.

MR. WESSEL: The back with the laptop.

MR. RIEMER: Thank you. My name is Jeremiah Riemer. On this question the north-south divide in Europe is often seen in terms of complying with or not complying with the rules of the various stability packets, but there's kind of a governance dimension to this that I think is sometimes overlooked. And I'm wondering if as an Italian living in London you have some thoughts about this? What I'm referring to is the great suspicion in the northern countries that the south is mired in clientelism. Now that's a big problem for Greece where both of the major established parties are big patronage dispensing machines. Your own country of course has an experience of kind of going back and forth between clientelism and shall we say technocratic house cleaning. And the generation that tried to make the historic compromise when the Euro communists were around, that was to some extent -- it's not appreciate today -- a movement for what we in this country since the progressive era have called good government. In other words there's a generation of Italians who are maybe leaving the political class now, it includes Prodi and Napolitano and so on, who are aware that you can mediate between shall we say good government and a welfare state that tries to have well managed collective provision of social goods. I'm wondering if that generation has left any kind of legacy on the Renzi generation and is in a position to sort of mediate between the north and the south from the sort of governance perspective that I just outlined?

MS. REICHLIN: Well, I'm afraid that that generation had left very little legacy because they were unsuccessful. They were very unsuccessful and corruption has increased if anything in Italy, so we had the mani pulite episode in the 1990s where the socialist party was very much involved, not the communists, the socialist party was very much involved in that corruption scandal. Then we had the big change with Berlusconi and then now the huge amount of scandals that are coming up again; you know, this goes in cycles, which involve everybody, the democratic party, the right, the left, everybody. So citizens are very much cynical now about the political class so we are kind of going through an Americanization of policies. I mean political parties, they are not rooted anymore to anything and very few people vote, the unions are very weak. So I mean we are in a transition, okay, so it's not clear what we are anymore. So we are not what we were but we are not the U.S. either, okay. So and in this empty space Renzi is taking a lot of -- you know, that's his space, but I would say it's more like a Latin America type of leader than a modern European leader. I mean he's a little bit strong maybe what I'm saying, but there is that danger.

MR. WESSEL: What about the UK? What do you think? Do you think that they'll vote to get out of the EU or do you think this is just a lot of domestic politics?

MS. REICHLIN: Well, I mean there is a risk. Of course that will depend on whether labor will win the elections or not, but there is definitely risk. This could be the next big accident. And of course the fact that the Euro Area crisis continues is not very inspiring for the anti EU party in the UK. So, yeah, this is something to be watched. I mean I think that -- of course if labor wins -- I mean nobody will be strong enough to govern on his own, but if labor wins the idea that maybe they will govern with the Scottish Independent Party, that will be a kind of UK. Crazy.

MR. WESSEL: Randy?

MR. HENNING: Thank you, David. I'm Randy Henning at American University. I wanted to get back to kind of this question of the design of QE. I make comparisons, I think about the comparisons to the Fed and the Fed programs in the aftermath of the subprime crisis and one of the things that was constructive about the Fed programs was Treasury indemnification of the Fed against loss in some of these programs. For example the TALF. There was a -- Treasury would cover losses that might fall to the Fed from their purchases or securities under this program. So we don't see this same thing happening in the ECB, for the ECB. And part of the reason is that you have political fragmentation in the Euro Area and disagreement among governments. You'd have to have an agreement between the ECB on one hand and the governments on the other to move this forward. And this is regrettable because if we could then we could have a basis for a more robust QE program in Europe I suspect. So my question for you is to what extent is the ECB hesitation for a robust QE program motivated by concern for loss on the ECB balance sheet, or is it really all concern about maintaining discipline on the governments whose bonds would be purchased under the program?

MS. REICHLIN: As I tried to argue that I think it's both and I think that the issue of maintaining discipline it has been the focus of the discussion. And so that's why I try to frame it in the way -- I hope I was sufficiently clear. I think that these issues of disagreeing and moral hazard is much stronger in the monetary union than outside the monetary union because of the lack of budgetary responsibilities. And so, you know, the suspicions that (inaudible) countries will eventually bail out everybody.

QUESTIONER: (Off mic)

MS. REICHLIN: Well, when there was a discussion of Greece that came out very clearly there was this -- also in the (inaudible) there was this discussion of seniority, okay, whether the ECB could maintain its seniority status. And I think this issue of seniority is still, you know, has been very -- is very much discussed so I think they do worry. And the decentralization of risk, you know, goes in the direction of coping with that problem.

MR. WESSEL: It seems bizarre to have a central bank that is willing to buy private assets and then to express concern about the credit risk of buying sovereign bonds. And this notion that somehow the worst case scenario is that the ECB doesn't get paid back on some Portuguese or Greek bonds when the alternative is the whole thing falls apart and -- it just -- it seems --

MS. REICHLIN: Yeah, I agree. But, you know, so it's a separation of countries.

MR. WESSEL: Right. I mean it goes to the question of the whole design of the thing in the first place. Just a little bit of clarification, Randy; so the Treasury didn't indemnify the Fed on QE and they refused to indemnify the Fed on Bear Sterns. After there was this pool of money in the TARP, some of that was provided a buffer to the Fed. And there was this talk wasn't there about turning the ESFS into a bank and do that.

MS. REICHLIN: Yes, that was rejected, yeah.

MR. WESSEL: And that was rejected. So it was on the table and rejected. That --

QUESTIONER: (Off mic)

MR. WESSEL: With the TARP money, yes, there was the first tranche loss would be the Fed, but the TALF was pretty small compared to (inaudible) of QE. Ben, there's a gentleman right in front of you.

MR. WALLACE: You mentioned recent Italian --

MR. WESSEL: Can you say who you are please?

MR. WALLACE: Oh, I'm sorry. Kim Wallace at Renaissance Macro Research. You mentioned recent labor reforms in Italy and in June of 2012 the European leaders agreed to the four building blocks strategies. The first two fiscal and banking unions have gone moderately well. The third internal markets reform is next up supposedly. Are you optimistic that the leaders will send a package to Parliament and Parliament will vote this year on reforms of capital, labor, and trade rules?

MS. REICHLIN: Yeah. I mean I think they will go at the pace in which they go, okay. So this has been on the air for a long time. They are late, but I mean if you hear them talking, you know, in the Parliament, on the political side they're all in favor so it's not clear why this is a delay. So I think we will get there, but the question is whether we will get there fast enough. And I think what has been a disappointment is the investment plan, okay, because this is really what everybody -- if you go to Europe now everybody says yes, but now we want to do growth and then we have this investment plan and so on. And then if you look at the investment plan it's nothing, okay, so that -- so maybe they need another shock. I don't know what though because we had France, Greece, you know. (Laughter)

MR. WESSEL: John Barry.

MR. BARRY: I'm John Barry, a freelance writer. I just had the pleasure of being in Greece for the last couple of weeks and lots of people are really unhappy there. Had a fascinating conversation with a taxi cab driver who says taxes on his Mercedes taxi have gone from about 600 Euros a year to about 6,000. I can't verify those numbers, but he's feeling really put upon.

MR. WESSEL: Did he say he was paying it or not? (Laughter)

MR. BARRY: I was in his cab for about 20 minutes and the sort of minimum flat rate was only 5 Euros, really cheap taxi fares. But my question is if the opposition party does win and says to the Troika look, we are achieving a primary surplus, not the three percent that had been the target, but one and a half to two, and that's really more than we can even stand, so we've got to have some kind of debt restructuring or else we'll just walk away. I have no idea how that would --

MR. WESSEL: Or else -- or else --

MR. BARRY: I'm sorry?

MR. WESSEL: I didn't hear what you -- debt restructuring or else?

MR. BARRY: Or else we will walk away. In other words we will simply stop paying on the debt. With the kind of unemployment they've got, I mean it's 50 percent among youth and 25 percent overall, you know, the sense I got from talking to people was that they thought it can't really be much worse. So what happens if you come to that kind of impasse? Will somebody finally say look, that really is more than we can ask a country to live with?

MS. REICHLIN: Well, as I said I don't think that they will unilaterally say we want to restructure the debt or we go out. I don't think they will do that because they know that this is dangerous, they don't want to get out of the Euro so they have said that. Seventy percent of the Greek citizens don't want to get out of the Euro so they will have to be respectful of the voters. And actually Tsipras has said very clearly that it does not want to get out of the Euro but that he thinks that debt redemption is the right thing to go, that some kind of renegotiation. So I think that there will be renegotiation, but probably not in the terms he wants, okay, so that they will reschedule. And there is the issue of the IMF. I remember that it is all official that in Greece. I mean 85 percent, 90 percent is official. So I think the IMF is out of the question, okay, because I think that -- I mean I can't imagine even what the American would say in that case, right, with the -- I don't think they would participate to their capitalization of the IMF in that case so it's all about the ECB, huh, so as Euro and, yeah, I think there will be a negotiation. I think that's what people think, that's what young people close to the issue think that there will be some negotiation, but at terms which are much harder than what Tsipras has been sold to his voters.

MR. WESSEL: Gentleman in the front here.

MR. LEIPOLD: I am Alessandro Leipold of the Lisben Council which despite its name is actually a think tank in Brussels and I live in Washington, so it's all a bit complicated. (Laughter) But as an Italian living in Washington in fact and observing Europe from this side of the Atlantic, you know, all these years of the Euro crisis I have spent my time arguing with American skeptics that they are always underestimating or overestimating the risk of a breakup of the Euro and the EMU because basically they underestimated the political will to keep it together. That's perfectly true, it didn't make all that much economic sense, it's not an optimal currency area, all the other things we know, but that there was this political will that kept it together all these years. I am worried that that argument is now wearing thin; that politics which was the (inaudible) of EMU up until now risks becoming a centrifugal force. And I don't know whether you agree with that. I think for that to continue to be the case I think we need a sort of quantum leap in the political resolve, a QE that was agreed in a not divisive way and not excessively compromised in the way you illustrated, and political will on other friends. And I just don't see that happening. So perhaps muddling through can work forever, I'm not sure but one -- I'm growing increasingly skeptical.

MR. WESSEL: Do you see a lessening of the political will to hold the Euro together? You didn't sound like it.

MS. REICHLIN: Well, I think that my -- I mean the political will is still there, but I also agree that people are getting tired, okay, so it's thinning. And I think how the Greek compromise will be reached will be instructive because the Greek debt is all official and in particular -- you know because it's through the ESM, ECB, et cetera, so if we go for restructuring Greece it means that the Italians also will be penalized, the Spanish will be penalized, not only the Germans. So that in that sense I think it's really interesting, it will be really interesting to see what is the strength of tolerance because also other peripheral countries will be involved in this credit event. So it's a dangerous situation that we're expecting will be a test of what is our political will to be together. But for sure the treaty is broken because everybody is in breach of the treaty now, so it will have to be changed. You know, that's the next step, okay, because no countries respect the deficit except for maybe Italy, but even now Italy is in breach. The more you respect it the worse your economy (inaudible) (laughter). So anyway, so no country respected the deficit. The Germans don't respect the macroeconomic procedure, that adjustment procedure that would recommend them to expand fiscal, instead they have this balanced budget thing. So everybody is in breach of some rules. So, you know, you cannot have a treaty that nobody cares -- that nobody respects because that's worse than not having any treaty. So some changes will have to.

MR. WESSEL: I think we have to end it there. Three things, one if you look to your feet if there's a paper or a paper cup there or plate, there's a garbage can in the back and we'd appreciate that. Secondly, if you haven't had enough economics this morning at 10:30 we're going to discuss the domestic and defense spending caps in the U.S. in the room next door, and thirdly, please join me in thanking Lucrezia Reichlin for an excellent presentation. (Applause)

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I, Carleton J. Anderson, III do hereby certify that the forgoing electronic file when originally transmitted was reduced to text at my direction; that said transcript is a true record of the proceedings therein referenced; that I am neither counsel for, related to, nor employed by any of the parties to the action in which these proceedings were taken; and, furthermore, that I am neither a relative or employee of any attorney or counsel employed by the parties hereto, nor financially or otherwise interested in the outcome of this action.

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