

Stanley Fischer (Overview Panel remarks)

Two thousand and twelve has not so far been a good year for the global economy, and the situation is unlikely to improve before the end of the year. Global growth for 2012 is expected by the IMF to be around 3%, a rate on the margin of a global recession. Some improvement is expected next year, but one has to qualify that by the fact that it is an almost inevitable feature of annual forecasts during a recession that next year looks better than the current year. Behind the slow global growth are major uncertainties about the economies of the United States, Europe, China, India, and Brazil – that is most of the world economy. But not all is gloom and doom, and in particular much of Latin America is looking relatively good: Peru is expecting 7% growth; Colombia 4-5%; and Chile around 4%; and parts of Africa are also growing well.

Because most of the world economy is in difficulties, all policymakers confront major issues and uncertainties, of which the prime source is the Euro crisis, and the second – also extremely important – is the U.S. fiscal cliff. Fixing the fiscal cliff is in principle relatively easy, if the relevant players cooperate after the election, but it remains to be seen whether that happens.

I'm replacing Mario Draghi on this panel, and that creates certain difficulties. One problem is that I'm not a European; the second is that I didn't get instructions from Mario on what to say – though I'm very glad for that. The third and basic problem is that I'm not Mario Draghi. Mario must be preparing for the ECB's governing council meeting on the coming Thursday (September 6), by working on the ECB's intervention strategy in the bond markets. So, I shall talk as an outsider, who has no serious inside information about what is likely to happen next. I shall also be in a situation similar to that of most people in this room, who are very concerned because they know that their economies will be seriously affected by what happens in Europe and what happens to the Euro.

The Euro is a political project, no less than an economic project. The project made remarkable progress in its first years, but the weaknesses of the construct have become increasingly exposed in the last five years. The weaknesses are evident in large budget deficits – some of them coming to light only after correcting inaccurate data that had been presented earlier, in cost differences among countries and resultant differences in competitiveness and the balance of payments, and in the strength of banking systems. It's noteworthy that one major difference between the United States and Europe is that after Lehman the United States dealt with its banking crisis up front, while the Europeans were more optimistic about the state of their banks and did not move rapidly enough to recapitalize them and make them healthy. That said, we need to recognize that no banking system, however strong, however well capitalized, can withstand a prolonged recession. The weaknesses are evident also, and importantly, in the failure of the markets and the political authorities to discipline countries who were clearly going off track.

Now we could have a discussion of why didn't we see this crisis coming. That could be very interesting, particularly as a lot of people did see it coming. But we are where we are, the Eurozone is where it is, and looking backwards isn't going to get the zone out of its difficulties without diagnosing the current situation.

One important result of the crisis so far has been much greater clarity over what is needed in the longer run to enable the Euro to survive and the Eurozone eventually to begin to grow. I would like to talk about three features on which the discussion has increasingly concentrated: a fiscal union; a banking union; and the sources of discipline – particularly fiscal discipline, within the system.

In terms of the fiscal union, a full fiscal union can come about in a full political union, or at least a political structure that deals with those aspects of economic interactions that need to be dealt with at the central level. This doesn't require a full fiscal union immediately, but it needs progress towards providing some European authority with the necessary legal powers

and funds to deal with the problems that require transfers to be made among the member countries. That could be done through dedicated taxes, significantly larger than those that currently go to Brussels. And, to obtain full legitimacy, it would be necessary to have more national political involvement in the process, possibly through national legislatures.

The banking union seems to be progressing more rapidly than expected, with the ECB gearing itself up for supervision at the level of the zone. However some elements in European national central banks and governments are skeptical about the desirability of Eurozone bank supervision being located in the ECB, and about the possibility of beginning zone-wide regulation by the start of 2013. Nonetheless, the move towards uniform banking standards in Europe, at least for the systemically important banks, is beginning to get underway and the work is proceeding.

The issue of discipline seems to me much more important than the attention it has received so far. I am very skeptical about the ability of the members of the club to discipline their weaker brethren in a way that would not create the sorts of tensions among countries that the existence of a European Union was specifically intended to prevent. To understand this problem, look at the results of the pressure that Germany seems to be putting on Greece at the moment and the inter-national tensions that is causing. And, if we were to go back to discuss why the Eurozone is in such difficulty, we would undoubtedly include the fact that the financial markets, by in effect setting national risk premia all to zero as soon as a country entered the zone, initially totally failed to discipline national governments. One could explain this by saying that the markets assumed that countries would be bailed out if they got into trouble. And some would say that the markets were right, for countries are now being bailed out. However not everybody who had Greek government debt was bailed out 100%. So the bailouts are partial and it's been very painful for some bondholders.

I think that the markets have to be there to discipline governments' tendency to run larger budget deficits than is wise, and that the idea of Euro bonds is really antithetical to that

possibility, because the Eurobond closes off a critical source of market discipline. That's the reason why some people think the best thing that could happen in the Greek case would be for Greece, having in effect defaulted, to stay in the monetary union, so that it will be well understood forever – or as long as the memories of market participants last – that countries can default within the monetary union, and that their debts are not guaranteed by the center.

Where are we now? Here I speculate, even though as a central bank governor, I probably shouldn't be speculating on what other countries are going to do. One has the impression that the politicians and the serious policy makers in Europe have understood the basic problems, and the eventual solution and are talking about moving towards putting in place the elements of the solution. That is a major achievement, because the discussion that we had on the Euro problem three years ago was different from today's discussion. The fiscal union issue wasn't central, nor was the banking union issue, and that's what people have begun to understand, and that's essential. But while the policy makers seem to be moving in the direction of understanding the issues and reaffirming their desire to protect and support the survival of the Euro, the public in Europe appears to be moving in the opposite direction. Furthermore, at this moment, we're waiting for a decision of the German constitutional court on September the 12th as to whether some of the mechanisms that have already been put in place to help deal with this crisis, are legal. And we're also waiting for the outcome of the Dutch elections on the same day¹.

What is not clear is what are believed to be the alternatives with regard to future developments in the Eurozone. There are a few possibilities. One is that everyone stays in. That's increasingly the hope of the European authorities. Second, there was a view for a while that Greece might leave the zone. There is less enthusiasm for that solution than there was, even among those who thought it would be salutary for one country to leave, so that all

¹In the event, both the German court decision and the Dutch elections turned out to be positive for the survival of the euro.

countries and all markets would understand that membership requires sticking to the rules. There are also more fears now about the extent of contagion than there were a year ago; this issue was well discussed in Kristen's Forbes' paper at this conference.

There is a third possibility, that the stronger countries could constitute a reduced in size but more robust Eurozone. That sounds simple, but one needs to think of the political dynamics of the discussion over who will be in, and who will be out. It is unlikely that those who want to be in will be willing to tell the others, "well, thanks it was nice to know you," and "you're on your own." This is not going to contribute to the building of Europe.

This brings us to the ECB, which can do a lot to keep the system from blowing up. Mario Draghi's speech in London contained the key breakthrough, which was that the ECB would intervene only when countries are in programs, undertaking supervised programs of adjustment to their difficulties. This is very important, though also a source of difficulty. We are still at a stage of the crisis in which the leaders of the countries in trouble appear to be in a state of denial about their difficulties. To anybody who's been in the IMF, this is an absolutely standard stage of any crisis: "Not us, our country is not like that." Then the realization dawns that a program is necessary. But the process takes time, and that time is wasted because during it the problem gets worse. At some point, countries in trouble will ask for a program, and when it is formulated, the ECB will be able to assist them in keeping interest rates at reasonable levels.

At that stage the contest gets under way. Can the politicians explain to their publics why they should want to have the Euro? Why, for instance, the surplus countries are benefitting from the existence of the Euro in light of their much better productivity performance, and the fact that their export markets have significantly strengthened because they (the surplus countries) have become the low cost producers. This is difficult, because in saying this, you in effect seem to be saying that the deficit countries are losing out. Their politicians will have to explain to their publics why this is a good idea for them as well.

Now, that's what the politicians have to do. The question is, can the politicians persuade their publics, and can their political processes support this process long enough, or quickly enough, so that the actions of the ECB and the programs which countries might undertake, will happen before the markets catch up with this rather slow process. That's the tough issue that's on the table.

What will happen and on what horizon? We don't know, but I'd like to conclude by quoting Jean Claude Trichet at this podium, I think a year ago. When he was pushed to the wall on the future of the Euro, he eventually said, look, the European project is a project in process. It was not set up with this particular aim of getting to a monetary union. We've had crisis after crisis since we started. At every stage of the process, we have heard the same story from Americans. He must have been thinking about the people sitting in this room a year ago. "You Europeans don't know how to make decisions. You're always slow. What phone number should I call if I want to speak to Europe? This dream is bound to collapse. We have heard that every time, and we have been slow. But, in the end we have emerged stronger from every crisis." That was a very good and moving statement about the history of modern Europe, one that should cause all skeptics to think again. In thinking again, we should also recognize that the thinking of European policymakers has progressed more rapidly than we would have thought possible a year ago, and that they are moving towards a sustainable framework for the survival of the euro.