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EVENT TRANSCRIPT

The Euro in Crisis: Global and Regional Implications

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URI DADUSH: The Euro crisis is much wider than just the GIIPS, Greece, Ireland, Italy, Portugal and Spain, and it includes, in my view, the Baltics, Bulgaria and, to a degree, Romania and Hungary as well. These are countries that either have pegged currencies to the Euro, or would find it very difficult to devalue against the Euro, as in the case of Hungary and Rumania, because of the large foreign exchange debts that they have.

Now, how did this competiveness and structural consolidation crisis happen? The story, if you read IMF reports over the last ten years, is actually very well understood. Basically what happened is these countries were less stable than the European core; when they came into the Euro, interest rates came down and confidence surged. The confidence surge was the expectation that these countries would converge to the richer countries of Europe, opposing [unclear] and institutions. This then led to a surge of domestic demand in these countries and the domestic demand surge in these countries, which reflected the rising confidence and the falling interest rate, raised the prices of domestic activity.

What is domestic activity? It raised the prices of domestic activity relative to international traded products. What are domestic activities in Brussels? Domestic activities in Brussels – I'm talking about the City of Brussels, not the European Union – what are the domestic activities in Brussels? Building is a domestic activity; it's not really internationally competitive, housing, hair cuts, restaurants, cafés, lawyers to a large extent, you name it, etc, etc. These are activities that are not subject to international competition.

The domestic demand surge in these economies led to the prices of these products to rise and relative to the price of traded products, BMWs. The price of BMWs is global, I think, or Fiats, or whatever, and the effect of this was to channel a lot of investment into the domestic activities of these economies and to accelerate the growth of these economies.

Another effect was that the price of labour, because labour is not so mobile inside of Europe as it is in many other places, and as it is not in many other places. The price of labour was bid up, wages were bid up in excess of productivity in these economies and in that effect, they loss massive amounts of competitiveness.

Two things happened: there was misallocation towards domestic activities and away from trader activities and at the same time these countries became expensive in international terms compared to not just Germany, although there were huge differences that have manifested themselves, so unit labour costs in many of these economies have risen 20%, 30% relative to Germany, but also vis-à-vis the rest of the world because while this was happening the dollar was devaluing vis-à-vis the Euro and the yen was devaluing vis-à-vis the Euro and there were these productivity increases in US and Japan.

Although we don't have the numbers, we suspect strongly that very similar phenomenon was happening in China as well, in other words China also gained competiveness vis-à-vis Germany on average. The bottom line is these economies have lost massive amounts of competiveness vis-à-vis the rest of the world.

Now, I go to the second point, which is that the fiscal is the result of the structural and the loss of competitiveness. Now, how did that happen, what is the line of causality here? Well, the line of causality is fairly straightforward. On the one hand, when interest rates came down in the troubled countries, the governments found very expensive stuff. They could have saved that money because after all it's a one-time gain, the fall in interest rates, but by and large they didn't save the money; they increased their expenditure – by and large. I mean there are very different patterns here in different countries, but this is the common story.

That's one factor that played, but the other factor that played on the fiscal side is actually more basic, is that these economies saw the rate of expansion of their government rise fairly rapidly. If you go to page two in your handout, the bottom left-hand side, you'll see that the annual growth of government expenditure... all the countries are not appearing there. The same graph is available in the report, but basically goes five on the left at GIIPS and the one on the extreme right is Germany. In other words, the rate of growth of government expenditure in Greece, Italy, Ireland, Portugal and Spain was very rapid, 3% to 6%, or 4% to 6%, or in the case of Ireland even more, 7% a year; in Germany much less.

Interestingly, for most of these economies, government expenditure didn't change much as a share of GDP; it just grows with GDP and reflecting the fact that tax revenues were rising rapidly. The only problem is that the underlying rate of growth of GDP was not sustainable because the growth model ultimately based on domestic activities was not sustainable.

This was already evident in Italy and Portugal many years ago and the growth rate slowed markedly. They had very, very slow economic growth, among the lowest in Europe, because they lost competitiveness, because the productivity of their domestic sectors was sluggish, and they were not able to maintain sufficient activities in the international sector, where they were losing market share.

Also Italy is a bit of a special case because Italy was already high income economy when the Euro was introduced. The convergence play in Italy was less marked than it was in the other 11 countries. Greece, Spain and Ireland saw very, very rapid growth, up until 2008 when the financial crisis basically exposed the fault lines in the system.

One of the interesting effects of the financial crisis episode is that the deficits of Spain, Greece and Ireland increased by much more than Germany or those of the other countries and the reasons are, in the case of Ireland, you have a huge expansion of credit finance centre – that was one special factor in Ireland.

In the other countries basically the crisis exposed the fact that not only was their manufacturing sector hit just like everybody else's, due to the slowdown of world trade, but their domestic sector collapsed, their housing model collapsed, the growth of their domestic activities was shown to be unsustainable. They lost in the non-tradable sector as well and, sure enough, governments saw that the rate of spending was entirely unsustainable because the tax revenue that they were counting on was simply not there.

This then is my second point, is the chain of events that go from the structural to the fiscal, and Greece is a bit of special case because, in addition to all this, there were a lot of infelicities in the way that Greece managed its budget, etc, and which put Greece in a category of its own in terms of the size of the problem that it has to confront.

The third point is very quickly how you deal with this issue. Well, this is where we ran directly into what everybody was worried about when they first set up the Euro; what everybody was worried about, people who had studied monetary was that you had very different setups within Euro, very different institutional frameworks, stages of development. We also had very inflexible labour market and you also had very limited equilibrating mechanisms across the European countries. You don't have a lot of fiscal space at the centre; 1% of GDP is the EU budget.

You don't have fiscal transfers, etc. This has all been written in 157 articles well before the crisis happened. The problem is that now you have a major asymmetric shock within the EU; this asymmetric shock is actually, what I'm arguing, a direct result of the way that the Euro was created, etc, and these rigidities are all coming into play, but you don't have, by definition, the ability to devalue or the ability to print money.

It's not just the inability to devalue that is important, because that's crucial because that would make it much easier to adjust. It's also the fact that you cannot print money. Why is that important? Well, if I lend money to the UK today, I know that the UK can default but the way the UK will default is by printing a little more sterling - so I'm going to see the inflation rate go up, but I'll see it coming.

How much can they hit me already, particularly around the short-term debt? How much can they hit me with inflation over the next two years?

In the case of Greece, Greece can run out of Euros; it has no printing press and Greece did run out of Euros, which is why they needed a bailout. Spain, if it doesn't do things right, can run out of Euros and so the short-term debt of Greece and Spain is also a worry.

Okay, so that's the constraints in a nutshell and the fourth and last point is that therefore, to survive and to adapt to the shock, the Eurozone has to use the available instruments much more aggressively than it would normally have to do if it didn't have all these constraints.

What are those available instruments? Well, you know the answer very well and I'm sure everybody knows that the answer is that you need to find competiveness again in these economies through major fiscal adjustments, much bigger than you would normally have to do if you had your currency, and that's not enough.

It could be enough because if you were in a major recession that lasted ten years you can reverse the rigidities over the last ten years; it can be done. It's just you're going to have unemployment at huge rates over the ten-year period. In order to do things faster, you have to operate more directly on wages, reduce wages. Spain is doing it, Greece is doing it, Ireland is doing it, and you have to undertake structural reforms to make your markets more flexible and competitive. This cocktail is very well known; it is the World Bank, IMF cocktail that just makes certain many parties are involved in developing countries over the last 30, 40 years; it's just this is the first time that the party is in the industrial countries.

The other element of policy that is available is there is no ability to devalue at the level of Greece, but there is the ability to devalue at the level of the European Union and so the Euro has come down, it has to come down, it has to stay down. European Monetary Policy, the European Central Bank, has to keep interest rates low for the foreseeable future, expensive monetary policy. In my view, Germany has to do the opposite of what it's doing at the moment, which it has to find ways to deflate its economy because it's one of the surplus countries and also the one that will benefit the most from the Euro devaluation.

The rest of the world has to help, the IMF, US, etc, etc, and the rest of the world has to help because of the size of Europe and because of the profoundness of the European crisis which actually affects the global recovery, particularly if, as is inevitable, if the sovereign debts problem multiplies and spreads to Spain and possibly Italy, etc, this is going to have a huge impact on the banking system in Europe and there's no reason whatsoever to think that you're not going to have a big global credit crunch of the type that we had two years ago if the crisis goes out of control.

That's my analysis. I'm staying away from prognosis at this point because of lack of space and time and I'll stop there.

FABRICE POTHIER: Thank you, Uri. I have to say it's challenging to cut people's presentations when you don't have a microphone. It's a very useful tool for that, but it was very comprehensive and clear at the same time. I would like now to turn to the rest of the world and to ask Ambassador Bhagwati or the impossible in the sense of asking him to maybe put on two hats, the expert hat as well as the diplomat's hat, to tell us how you read this crisis and maybe, even more importantly, how you read the possible implications of the crisis for one of Europe's important partners, India. Thank you.

AMBASSADOR JAIMINI BHAGWATI: Thank you for this opportunity to talk to this select audience. It's nice always to pick up with Uri. I see familiar faces out there. As you rightly said, it's an impossible task, so I'm going to be short – I was told about ten minutes. What might happen in trying to brief is that I may misallocate my resources and focus too much on one point than the other, in which case just tell me straight later on in the question and answer session when you can ask me to elaborate on something I didn't spend too much time on.

To begin with, one can't disagree with Uri ever, but on this particular occasion I agree with him in terms of the analysis and what he is suggesting. What does it mean for the rest of the world and particularly the developing world? And then I'll come to India as well. To the extent that the expenditures in Euro Land cannot be reduced, whether it is because of the inelasticity of social security, pensions and other such payments, where it's just not possible, and to the extent that the relatively surplus countries within Europe cannot provide those savings within the framework of some kind of arrangement agreement where the credit risk part of the issue is satisfied.

I mean by that, countries like Germany and a number of countries within Europe's lending, by providing the resources of the ECB to other countries such as Greece. To the extent of countries other than Europe, the rest of the world, whether it is through the IMF or through some other channel, have to divert its savings to Europe; that is the only way. If you can't do it within your own country, then you go within the European Union, you can't do it within the European Union you'll have to go to the IMF and, as some of you might know, countries like Brazil, China and India are net contributors to the IMF, no longer borrowers from that institution.

I need to say a word here about the relative sizes of these economies. When you look at Greece, it has been talked about a lot, but, if I remember rightly, it's only about 2.6% of the Euro economy. If you look at Portugal it's 1.8%, Ireland, 1.8%; Spain is substantially bigger; it's 11.7%. Germany, of course, leads at 26.8%. Why do I refer to these numbers? While it is a calamity for Greece in terms of its inability to print Euros, it is not a calamity for Europe as a whole, when you're 2.6% of the Euro economy.

When I spoke about how you have to suck in savings from the rest of the world, when even within the Euro land, these worst affected economies are relatively small; it's not as if the rest of the world will be affected to that extent.

I think the story is somewhat different when you come to Spain and, very frankly, I think I need to mention the UK. It's not part of the Eurozone, as such, but it's definitely part of Europe. When I look at the UK, I'm worried, quite frankly, in terms of its medium-term situation. They may find various ways to address their problems; they do not have the competiveness problems like Greece or even Spain because they misallocate resources, as Uri said, to activities which are essentially domestic.

The leader in the pack was construction activity which leads to excess capacity and you have a lot of debt, which fuelled that construction activity and you don't quite know what to do with this once those apartments are built and there's nobody out there to live in them.

UK is not in that kind of situation but there are different complications. It has its own currency and prints that money, whatever money it needs, but you can do [unclear] but it might lead to inflation. Already, compared to the developed world, compared to the OECD countries, countries like India are leading the pack in terms of inflation.

Our poor inflation right now is over 9% in India and when you think about what is going on in the countries which have been hit hard post 2008 by recession, inflation is far from everybody's mind - in fact, in terms of cutting down on the fiscal, in terms of improving the fiscal's balance within government, because in Japan earlier the concern was deflation, not inflation.

For us, looking at the availability of capital which has been bumped in because of easy monetary policy, it has led to capital inflows into countries like India. You asked me specifically about India, so as far as India is concerned we are grappling with the straight problem where at one level as a capital deficient country we would welcome foreign capital and you might see an inconsistency of what I said about how international savings have to come to Europe.

There's a distinction between private capital and government capital. It's private capital which is much needed within Europe, maybe looking for higher returns in countries such as India, and creating problems for us in terms of our own exchange rate management. Uri referred to competitiveness; obviously we're very conscious. We have our own currencies so, to that extent, we are not has constrained in terms of our competitiveness compared Euro land, but we are conscious of the fact that competitiveness will be affected.

A country like India, the capital account is only partially convertible, so to the extent that we have adverse current account balances beyond a certain amount. We have no problem with an adverse trade balance, but if you have a consistent adverse current account that can be a problem. Recently the current account has been showing an uptake. It has gone up to almost minus 4%. That's where we are with regard to India.

Coming back again to Europe and to UK and the US, one aspect of the current situation which Uri may not have mentioned because of the shortage of time is we are very concerned about what we are seeing in terms of some countries perhaps recovering but jobless recovery. This is particularly true of the US. Jobless recovery in addition to the economic problems also creates political and social problems and makes certain kinds of policy choices not available to the government.

You might have become a little more intransigent. This weekend we will have the G20 leaders meeting at the summit in Toronto. To the extent that the countries can agree, the world will be better off and wholly indifferent to the fact that Germany perhaps is tightening when it should not be tightening. I think, as far as the US is concerned because we are not talking about privileged information, the US would prefer to hasten slowly, in Martin Wolf's terms, and not rush to correct the fiscal balance.

Here I would tend to agree with what some of observers, like Paul Krugman and others have said, that ideally from India's point of view, I would agree that there might be a divergence of policy choices with some of the smaller economies in Europe aggressively trying to correct their fiscal balance but some of the larger economies should not proceed in the same way because it will have a diferential impact, not just within Europe, but also for the rest of the world in general and India in particular.

I also see some incipient science, given the rates of growth for some of the Asian countries, not all, some, that there might be a minimal amount of structural decoupling of Asian countries from OECD countries. This is the first time – well, I don't know about the first time – perhaps this is a change from the past. Usually, take 2008, for instance. India was affected in the following way. Financial crisis in the US, leading to problems in Europe and so on, banks and other financial funds, the first description of that problem in India was drying up of trade credit.

Immediately, the short-term trade credit dried up, just so the Central Bank had to go in to inject because our capital account was not fully convertible so the banks could not immediately respond. The Central Bank, which is the reservoir of all foreign trades in India, had fiscal debt.

The second thing which happened was the decrease in demand led to obviously decrease in demand for Indian goods and service, so it affects our trade balance and, to that extent, affects that part of the economy which is dependent upon exports. However, at the same time, the decrease in demand for an energy deficient country, for a fossil fuel deficient country like India, also had the positive effect of oil prices going down from $140 a barrel to $40 barrel, so it's a strange situation.

While the decrease in international demand is bad for us, in some ways, given that this is as one good, the single largest item on our foreign exchange outflow bill in terms of the trade and balance that we had, we are helped by demand going down because we are very dependent on imported oil and gas.

Let me try to summarise. First, I agree with Uri that competiveness is the issue and here I'm personally somewhat surprised at how much the ten-year... Let's take one example, the ten-year government bonds of these countries, France, Germany... I've jotted them down from Reuters. France is at 3.065; that's the yield on a ten-year government bond. If you look at Germany, it's 2.62. These numbers are not usual, 44 basis point difference between the ten-year Eurobond of Germany vis-à-vis that of France. What is the market looking at? What is it concerned about?

This is not usual. They are both very large economies but if you look at the UK, it's another 35 basis points above France. If you look at the US, it's somewhat close to where France is. This kind of divergence in the financial markets in terms of risk appetite for what one would consider if you were to believe SMP and Moody's - but after 2008 nobody does - is that they are all AAA rated. Why is there so much divergence? They're all sovereign. If you think of UK, France, Germany, US, all AAA rated sovereigns with impeccable credentials in terms of their credit history, not too far back in the past though. If you go sufficiently far you can find jinx and drama.

As far as developing countries are concerned, we are thinking of the unthinkable, which is what all risk managers should do, which is what happens if the mid-sized economy gets into trouble, which can no longer print money. I'm abstracting from just the Euro problem. Within the Euro land I think the larger economies will, if there is political appetite to support the smaller economies, be able to nurse them back to competitive health.

Here I'm abstracting from the politics of it all, the last three demonstrations and whatever. I'll just stop here, although stopping somewhat abruptly. Please do ask me for clarifications in the questions and answers.

FABRICE POTHIER: Thank you very much, Ambassador Bhagwati. I could see that you could not resist putting the expert hat and then switching to the diplomat hat. I think it was very rich and very interesting, setting the bar very high for you, Sinan, to bring the same critical analysis first of what are Uri's key points, the four points, but also a broader picture.

SINAN ÜLGEN: Thank you very much, Fabrice, and it's a great pleasure to be here as in these words, it's my "bapteme de feu" with Carnegie so I'll try to reciprocate.

I actually have a perverse story to tell you because what you've been reading about the Euro and the Euro crisis has rather been a dismal story and, I just flew in from Istanbul, I just want to share with you the consequences of the Euro crisis for a country like Turkey.

The way that I can actually summarise all of this is that Turkey has been relatively unharmed and comparatively a much more attractive place in the aftermath of the Euro crisis. Now, why do I say that? Let's look at a number of the different dynamics that really underpin this picure, growth, for instance. Turkish growth has been a remarkable story this decade, averaging around 6%, until the big financial crisis. In 2009 growth sharply decelerated and ended up at around -5%.

But an interesting thing is that as the Eurozone itself started to feel the impact of what's now being called the Euro crisis, Turkey rebounded, its growth in the last quarter of 2009 was about +6%, the first quarter of 2010 we expect growth in double digits, 11% or 12%. The year-end estimate for Turkish growth will be around 6%.

On the fiscal side Turkey continues to show a primary budget surplus, so before the crisis it was really around 3% or 4% of GDP; now the Euro and the global crisis has come down, but nonetheless there's still primary versus surplus. There's still a budget deficit because of the debt repayments, but nonetheless on the fiscal side, the end of the year we expect a budget deficit of -4% -5% compared to GDP.

Even with that figure, the public debt to GDP ratio, if you think about how many countries in Europe are still being able to fulfil the Maastricht area, Turkey's figure will be about 45%, so public debt to GDP.

All of this translates into a much more attractive outlook for Turkey as the country in terms of portfolio investments and also in terms of FDI. Just to give you another figure, there's an issue called CDS, Credit Default Swaps, which actually measures the riskiness of the country. At the beginning of 2008, Turkey's CDS rating was way below those of the countries in Europe, Spain, and also the new member countries, Bulgaria, Rumania and of course Greece.

Now, today, Turkey's CDS risk is much better than all those countries, including Spain, so this is in a way, the perverse relationship, the perverse impact, if you want, of the Euro crisis on a country that actually has quite a significant economic interdependence with Europe.

The question is why has this happened and here I have basically three points that I want to cover. One is that the economy has been able to switch very rapidly to a growth model that is fuelled by domestic demand instead of exports, so instead of the trade relationship – and Turkey is actually quite a modern economy so the share of exports and imports to GDP is 35%, the global trade volume is around $250 billion – so it has quite a large impact with respect to trade in itself is quite a large element of our overall economy.

Nonetheless the Turkish economy has been able to switch to a growth model based on domestic demand. The second aspect is that when you look at how the different channels through which the Euro crisis could have affected Turkey, it's interesting to note that most of those channels have not really had a big influence on Turkish economy.

Now, what could those have been? One is obviously the exposure of Turkish banks and there we find ourselves in a situation, like a number of other countries, where we see that underleveraging has been a beneficial impact in order to really address the impact of the crisis. The Turkish economy is an underleveraged economy.

We have a growth to GDP ratio of about 35% and that's very low by international standards, so the financial channel through which the Turkish economy could have been affected therefore has been quite minimal. The Turkish banking sector has been very strong, very resilient. You might say that the country has actually had to pay an enormous price to clean up its banking sector back in the 2000/2001 crisis, when it cost us about 35% of our GDP.

Nonetheless after that, the rules that have been introduced in the banking system, the regulatory rules, the banking oversight and so on, allow the banking sector to remain strong. Now there is no problem with regard to the banking sector, no problem with regard to long-term loans and also in terms of its international financing the Turkish banking sector is in a good position. The loan to deposit ratio in Turkey is 70%, which means that the banking sector actually finances its loans through its own deposits.

Now, what does that mean? Whether this is perhaps a bit too rosy a picture that I paint of the Turkish economy is a sustainable one. That is a question mark because so far the growth picture, the fiscal picture that I've shared with you, was actually rebound and there was a very strong rebound effect in what I've told you.

The question is whether this is sustainable and many people in Turkey do hope that the crisis that we are discussing here today, that has affected many of our trading partners in Europe, will soon be addressed. If demand in Europe does not pick up sooner rather than later, then I will not be able to tell you the story if I sit here six months down the road or one year down the road.

Yes, Turkey has by and large been unaffected by what's going on in Europe so far, but there's a big risk element, and the way forward in that sense is unclear. Just yesterday in the Turkish newspapers there was an interview with some of the Turkish exporters and they were extremely worried about the austerity measures that were being flagged in some of the large EU economies, in particular in Germany, which remains Turkey's number one trading partner. The demand side is going to be very important, whether demand in Europe will pick up.

The second issue is really on the FDI front. I told you that the Turkish economy is quite independent of the European economy and the FDI flows originate in 86% from Europe. If this economic downturn continues to become a very serious issue for the European economy, obviously on the FDI picture as well Turkey will not be able to continue its economic performance.

Having said that, I want to perhaps conclude with a political assessment of what that means. I am constantly being asked when I am back in Turkey about what that means for the Turkey/Euro relationship. In the short-term it is clear that this economic crisis will lead to a more introverted Europe.

It will mean that in Western capitals that EU leaders will have their hands full with trying to deal with the economic crisis, in trying to explain to their domestic constituency why is it that they have to take all these unpopular policy measures and, viewed from that perspective, enlargements, and especially through a country like Turkey is going to be a difficult sell for European leaders.

This is a picture in the short-term. I, however, tend to believe that in the longer term things will be reversed because if you look five years, ten years down the road, assuming that Turkey maintains its economic performance of growing at 5% or 6% per annum, five years, ten years down the road we will see a much different Turkey where convergence between some of the EU countries – and I'm not even talking about Rumania and Bulgaria, the latecomers – but Greece, is going to happen with a much rapid pace.

One of the reports that I've received was that, for instance, for Greece, Greek GDP will return to its 2008 level only by 2017. When you compare Turkey to a country like Greece down the road, I think it's going to be much easier for Turkey to be interpreted as an economic asset for the EU with its large economy, its growing economy and really its resilience in many ways.

Already Turkey, when we see about this drop in demand by countries that have to pick up demand, Turkey is one of the demand generators for the European economy and I think this is going to continue and, from that perspective, maybe this economic crisis will turn to Turkey's advantage in the long-term.

FABRICE POTHIER: Thank you very much, Sinan. That was a very refreshing perspective and I think your concluding points on the political aspect are those that I think we all have to keep in mind here, that we are entering an age of austerity also for foreign policy in Europe and we have to think well about the implications of that. Let me now open the floor to see if we have some comments or questions and that we can have a round here for our speakers.

JIM NEUGER: Jim Neuger from Bloomberg News. I have three questions, or two and half questions. The first two are for all three gentlemen. If Greece, for example, were to default, what would the consequences be for the non Eurozone throughout the world, considering the impact on the European banking system and the availability of investment capital? And then related to that, do you think that the [unclear] reforms of the Eurozone governance, European leaders are making a mistake by not building in some sort of orderly... realising that defaults can never be orderly – but by building in some sort of mechanism for dealing with sovereign defaults in the future?

The third one, Ambassador, you raised the point of the recent outperformance of German bonds vis-à-vis France, the UK and the US. You didn't really answer the question of why you think this is happening, so maybe there is perhaps a flight to quality element going on there. My point in that flight to quality might be speculation on a Eurozone breakout.

FABRICE POTHIER: That was your two and a half questions. I think we have a set of questions from Thomas.

THOMAS CARLTON: Thomas Carlton from the European Council on Foreign Relations. I also have a question for the three speakers, or rather three slightly rude invitations to gaze into a crystal ball and that's perhaps guaranteed to get a groan or not. I was wandering whether I could ask you to give us your sense about what the Euro crisis has really done in the sense of the second chapter of the financial crisis is to accelerate very substantially the risk and perhaps the actual decline of the high income countries versus emerging or newly risen powers and whether you'd expect the relative strengthening of the competitive position of the newly rising powers to continue over the next 20 years.

FABRICE POTHIER: Thank you. Let me turn to the Ambassador, then Uri, then Sinan to address those three and a half questions.

AMBASSADOR JAIMINI BHAGWATI: If Greece were to default. I think when you look at the spread for the Greek bonds – I have the numbers somewhere – it's over 900 basis points, close to ten. That is ten percentage points; it's not meaningful to talk about those kinds of spreads because I don't think there's much trade of Greek bonds because these are illiquid already. To a certain extent, the market has already factored in a Greek default; it's not a conventional default because it's got a safety net in terms of the larger countries having put together this package between 7th and 9th of May that we're all familiar with.

It's more, in my opinion, a question of restructuring, how you define restructuring, and I think what is going on right now is restructuring of Greek debt, so it's define the conventional definitions of restructure, which means already defaulted, but effectively that's where we are at.

What would happen to the rest of the world or what does it mean - that there will be a huge impact on the rest of the world? I think not because I referred to the size of the Greek economy. I think in terms of its total Eurobond issuance in terms of what the Greek Government owes to its creditors, it's about 123% of its GDP which would roughly be €350 or €370 billion. When you look at it in terms of the size of the Euro economy, or just the size of the German economy which is ten times that, I think the problem can be contained if there is political will.

It's a different matter... I don't think it's as much economics as politics. Does Europe want the Euro enough to pay the price for the de facto restructuring of Greek debt? Because, to some extent, the question is of European banks, as we know, French, German banks are exposed to the bonds issued by Greece. The answer to that is yes because what we saw between 7th and 9th of May was that the Eurozone countries got together and so did the EU countries, and they decided that they will not allow this to happen. They agreed for the ECB to provide the market, either buy or [unclear] Greek Government bonds.

To that extent, if I were to look at it from outside, I would say that as of now I do not see any cracks in that political will to bear that. The consequences for the Eurozone itself and for the EU are large enough to provide the political will for that to not happen, so to that extent you might argue that it's wishful thinking for people outside the Eurozone.

It's not just wishful thinking. If the consequences for the Eurozone and for the EU 27 countries is bad enough, so that is in some way an insurance that political will will be found to keep this together. That's my guess for now.

You also asked half a question on the flight to quality divergence and I didn't quite explain what it meant. I think it's a reflection of the numbers. If you look at the fiscal balances and I have them here, a printout, and the source is the Fiscal Monitor. When you look at Germany and you look at France, you're absolutely right, there is a divergence. When you look at the primary balance for 2010, France is -6.0 as a percentage of GDP. Germany is - 3.4 and the UK is -8.8.

If you look at France and the US, I think the US has always been the country which has a currency which gives it some senior international reserve currency, even though the current situation as far as the US is concerned, it's -9.2 and, as you might recall, I said the US and France, their ten-year bonds are fetching the same yield, but France is at -6.0 but the US is a different story.

I don't quite know where to proceed further in terms of answering your question. I was making a slightly different point that when you look at the credit rating agencies, what is it that the market is doing, what exactly is it assessing. I think it is trying to assess just how much will there is domestically in these countries to address their fiscal balance problems.

I don't think the market is at all thinking in terms of the credit risk aspect of it, because these numbers are nominal. Those bond yields that I mentioned to you are nominal; they are not inflation linked bonds. If you look at inflation linked bonds and then compare across countries, you'll get a better credit risk strength. Here, that is also inflationary expectations because, as you know very well, you're holding a bond and there is inflation, to that extent, you veer down because your return is going down and there are differential inflations in these countries.

If the inflation is different in different countries, even though the bond yield is the same, you're getting a different real return, so I think that's what the market is stressing in terms of inflationary expectations based on the fiscal balances.

FABRICE POTHIER: And then there was a crystal ball question.

THOMAS CARLTON: Would you say that the Euro crisis as part of the crisis is an accelerator of the relative decline of the high income countries versus...?

AMBASSADOR JAIMINI BHAGWATI: I don't think it's a cause, I think it's a symptom. I think the only difference is competiveness. It is the long-term reduction in competiveness vis-à-vis other countries. The financial crisis is definitely not a goal [?]. It's just a very abrupt and somewhat rude reminder about where the competiveness balance, how much it has moved. Because if you continue to consume, whether domestic goods and services or from outside based on that, at some point in time there's a come-uppance, so that's what it is.

Competiveness can go down; competiveness can stabilise and go up again, depending upon scientific developments. I think all of us have seen... I was quite taken up by this news report about somebody trying to find out through some image about Alzheimer's disease. Who know where the world is going in terms of such achievements, which have huge implications – just taking one isolated example because I saw it in the newspaper today.

It's difficult to go out two or three decades, I don't know, but the fiscal crisis which is the public aspect of the private crisis and the public sector have stepped in and therefore all their balances have become negative, it is just a mirror image of what the private sector did. There I think it's a bit difficult to say that competiveness has deserted OECD countries altogether. It's just a fact of life that countries would catch up, so either you reduce consumption or you come up with something else.

FABRICE POTHIER: Before I turn to you, Uri, let me inject one additional question because I missed Paul's finger.

PAUL ADAMSON: Paul Adamson from E!Sharp Magazine. I have a question for each of the speakers as well. I don't want to misrepresent your views, Uri, but you said in respect to your point three that the strengths of the Union, the fact that Greece, for example, can't print Euros like the UK can print sterling, I don't think you referred too much to the future governance of the Euro or its rulebook going forward. I'd like your views, if possible, on what are the channels, your focus on [unclear] channels, I'd like your views on that.

Since Jai referred to an article yesterday that said yes, in haste or slowly, whatever, he also refers to... I hope you don't mind me saying, Jai, that there's no big deal in what is done as long as it's done sensibly, quote, unquote. I just wanted your perspective in how credible, how important is the [unclear] in getting us, us being Europe, out of this crisis.

A question to you, Sinan, although you expressed concerns about the export market to Germany, you were seeing various ways to justify yourself and said how happy you are about the domestic demand that you saw in Turkey and are there any tips you can give us poor Europeans [overtalking] including the UK, by the way, outside Europe, about how to do what you're doing so well.

FABRICE POTHIER: Thank you very much, Paul. Three very interesting questions. What we're going to do is we have a bit more than ten minutes left, so maybe, Ambassador, if you want to finish your series of answers by addressing Paul's question, and then Sinan and then Uri will have the concluding comments. We have just one or two minutes for Sinan and then Uri will conclude, thank you.

AMBASSADOR JAIMINI BHAGWATI: One, credit dealing is fine, ideal, if you are doing that as an interim measure, as something that you do to get the fiscal house in order, to get competitiveness back, so you do need also voluntary cuts in consumption, in that order. It obviously has to be temporary and perhaps the UK still has some room for quantitative easing, but it must do more than just look at the City for it to recover. It has to find competiveness in other areas of its economy and there – I forgot to mention this – financial sector regulations and that's what the world is looking to, the EU and the US and others to get their act together quickly on financial sector regulation.

SINAN ÜLGEN: A couple of questions then very fast. On Greece and what happens in Greece from a Turkish perspective, I can see three consequences. One, the cost of capital issue and that's important for a country like Turkey that has a structure of both current account deficit and therefore this stressful episode of Greek default may raise risk appetites or risk aversion rather and lead to an increasing cost of capital.

The second one is the more long-term Euro/dollar question. Indeed, if there is a crisis with the Euro, the Euro-Dollar parity might continue to change and that creates a risk for Turkey in terms of an adverse shock in terms of trade, given that most of Turkey's exports are to Europe whereas imports are largely dollar denominated. If the Euro loses strength, that's going to lead to adverse consequences on Turkish current accounts, for instance, or again as a chronic deficit.

The third one is really a more political question. It's really whether this type of stress within Europe can lead to a structural change within the governance structures of Europe. We've already talked about the economic governance, but whether that can in time lead towards a Europe where you see a core group of countries going forward with deeper integration and whereas the other EU countries will remain on the periphery. I'm talking about more of the type of concentric circles of multi-speed Europe and that certainly will have an impact on how Europe is with its own neighbourhood and, in particular, with countries that it starts negotiations.

Thomas, your question about what I see in terms of the decline, I think Europe and not EU – let me rephrase it – has a big image problem. Because I think here the perception is more dismal than reality. The more countries that are in Europe's neighbourhood look at and read about what's being reported about the economic difficulties, widely reported by Bloomberg and Herald Tribune and so on, that creates a problem and people tend to believe that Europe is a waning power.

I think here the perception goes way beyond what it actually means in practice for Europe's economic might and how you deal with that is another question, but I just wanted to make that point.

Recommendations: two, if I may. One is really attitude towards work. I think that is the main difference and is going to make a difference. I'm not here talking about the Asian type work ethics, but nonetheless we have the same approach towards work and the Turkish people believe that there is a lot of catch-up and therefore work is not something that you can evade. Average working hours in Turkey have actually gone up significantly in manufacturing from 46 to 52 hours a week. Compare that with 35 in some of the countries and you see where the difference in competiveness comes from.

Secondly, it's about regulations. I think one of the advantages that Turkey has had has been to really adopt the type of regulation - because we're a negotiating country – that is more pro growth, but leave the type of regulation that is less pro growth aside until the time when we have a new member. That I think has helped the economy into its more dynamic growth pattern.

FABRICE POTHIER: Thank you very much, Sinan. Uri, you have the concluding remarks, addressing the questions, so do everything to try to give us a sense of what your take is on those points.

URI DADUSH: First of all, I agree that Greece is [?]. If the IMF program works, Greece has 150% of debt to GDP, if it works, three years from now, which is a huge number for a country with the governance and the reputation of Greece. Turkey had a debt crisis with 50% of GDP debt and Argentina before that with 50% to GDP debt; Russia also had a 50% to GDP debt.

This is why the default question on Greece is not going to go away and the markets are very aware of it. I agree with what Jai said that to a degree this has already happened. If banks were marking to market, I know when I look at my small portfolio at the end of the month I mark to market; I don't look to find the... face value. I look at what it's worth so I hope the banks are doing the same thing as I do in my own little way and, if they are, then Greece has already defaulted.

Now a little more seriously, I like to think of the consequences of default under two scenarios. One scenario is where the world has recovered and the markets are confident that Spain and Italy have undertaken the necessary measures. Under that scenario a Greek default which essentially recognises that the value of the bond has gone down, etc, will never lead but can be managed without responding to pressures.

The other scenario is the scenario where we don't have a consolidated recovery and we are continuing to be extremely concerned about Spain, Italy, etc, which happens to be the situation right now. In that scenario, I think that default could have disastrous consequences in the sense that it will affect confidence in a huge way and then we'll have repercussions through the financial channels, to the trade channels, etc, which is why I understand that the European authorities, the IMF, etc, have not received it with a default, a rescheduling of the debt in the current context.

I think they will need to do it but they should do it at the time when we feel that things are under control and right now the world recovery is progressing and let's hope it doesn't get diverted.

If you see the real action in these countries, I think the stage will be set for... By the way, the default can happen in many ways. Jai and I worked a long time ago in the World Bank on a concept called Debt Forgiveness. The word forgiveness does not appear to be part of the European lexicon at the moment, but it is in development. There are ways that the debt can be not paid back without default, if you follow my gist, but of course the political, you have to be able to justify that.

There are all sorts of ways provided the environment is good. Resolution mechanisms, I can see pluses and minuses. I understand why there's always a mechanism and that gives the wrong signal, so it's not clear to me it's going to add very much because these are sweet generous [?] situations. We only have so many countries that can go past the European Union and each of them will be approached differently.

Then on the question of did the crisis accelerate the rise, the relative rise of the emerging market, I like the way Jai thinks about it, which is what is underlying driver here. Whatever you think the underlying driver is, I certainly feel that the crisis did accelerate the change in the relationship.

The world today is already different than it was two years ago. China's role, India's role, particularly China's role, but India's role, Brazil's role, is certainly more prominent and the crisis, even with the recovery, has left us with a heavy legacy in industrial countries, much higher debt, lower income relative to the trend, fragile banks, a lot of excess liquidity that we don't quite know what to do with, etc, so I think it has accelerated the process.

The future governance of the EU is something I try to keep away from, partly because it really goes beyond my area of expertise - but I'm willing to make a couple of broad statements. One is: whoever thinks there's going to be some fiscal federalism that comes out of this, he's certainly not living in the world that I know and it seems to me the opposite. It seems that the crisis pushes back any prospect of fiscal federalism in Europe for a good decade or two.

The other point I'd make is that it is possible that this crisis itself can be interpreted as a crisis of adolescence in the sense that it only happens once in your life. It's very painful and it can either turn you into a neurotic wreck for the rest of your life or you overcome it and become normal. I kind of fell in between.

The main point is that if you follow the dynamics that I tried to take you through, actually a lot of it was coming from the birth of the Euro so it may be that you can actually fix this problem now, that we are going to be in a stronger position and we don't need necessarily... nor are these mechanisms forthcoming, in my view.

I think there are some fairly obvious things that need to be done, like for example we should start worrying about competitiveness – to use the American expression, duh – we should start worrying about competiveness, we should start worrying about internal imbalances in Europe. People have said the internal imbalances in Europe don't matter; how they not matter? That's what the crisis shows is that they matter big time.

We should worry about them, we should worry about competiveness, mechanisms for monetary competiveness and the fiscal stability pack just needs to be scrapped and rethought altogether. For example, in the report you will see that my view is not only that the fiscal stability pack is wrong in setting limits because during recessions you're going to play to those limits and you shouldn't [?] those limits.

It also gives the wrong signal because the countries that went into the Euro [should?] be running large fiscal surpluses in the first few years to offset of this huge confidence effect. The whole fiscal stability framework needs to be rethought, become a much more flexible animal and a cooperative animal.

FABRICE POTHIER: We need to bring you to Berlin because I think there are things that Berlin ought to hear, especially on your last points. Thank you very much, Sinan, Ambassador Bhagwati, Uri. Thank you to everyone for coming and inaugurating this meeting room. Thank you again.