OLIVIER BLANCHARD

Fred Bergsten Senior Fellow at the Peterson Institute for International Economics, former Chief Economist of the IMF

Thank you, Thierry, for the very kind words, and for the invitation. Let me start with two caveats. The first one is that in my previous job at the IMF, I had 200 people feeding me daily information about the world. What happens when you leave the fund is that you find yourself to be a team of one and you have to do the work yourself. You cannot replicate what the 200 extremely competent people did for you, please take this into account. This implies that these are humble remarks. They are more remarks than an encyclopedic tour. I have no pretence of knowing everything which happens around the world, and it may be that when you ask questions, I may say that I just do not know.

The second caveat is something that echoes what Thierry just said, which is that I was tasked with thinking about what happens over the next few years. In a way, the excitement is in the medium term and the long term. These evolutions that we have talked about, from inequality to populism and so on, have some implications for what happens soon. However, the big issue is where we end. That is what was taken on this morning in the various sessions, and I am going to avoid talking about these things and just focus on the next few years.

The question is, how should we think about where we are? As people have said this morning, these are very strange times. These are indeed schizophrenic times. On the one hand, if you look at the real economy, and by the real economy, I mean output and inflation, things are as good as they get. You have to go back very far in history to find a situation in which the economy, the purely economic situation, is as impressive or as benign as it is today. That is an important point, because in the general climate of pessimism, these facts are often just swept under the rug, but the reality is that.

At the same time, if you turn to the politics and the geopolitics which were discussed at great length this morning, I was going to say things are as bad as they get. However, it would be much too optimistic. They can get much worse than where we are. You have this tension between the two. As an economist, you see the world as it is now, as being in fairly good shape, and elaborate on that. Then you see the geopolitics and the politics being terrible. The big challenge for an economist is to think about how these political and geopolitical risks can translate into economics in the relatively short run.

What I want to do is first talk about the real economy, where we are today, and then talk about what I see as the economic risks. By economic risks, I mean leaving aside the geopolitical and political risks. Then I will come to a list of political and geopolitical risks and think about how they may affect things sooner rather than later, so let me do that. Let me start with where we are, so the economy today. If you are in that business, you know that the world economy has slightly slowed down in the last 3-6 months, not by much but enough to make some people worry.

I do not operate at that high a frequency. I am just thinking about where we are in terms of this year and next year. There, the numbers are very impressive. If you go around the world, the US has the best macro economy at this stage in a very long time. As you know, regarding unemployment, we did not know, when the recovery was taking place, how much and how far we could take unemployment down before we saw signs of inflation. Some people said six and some people said five.

We are now at 3.7, and there is very little indication that we have gone too far down. We are probably fairly close to where we should stop, but that is incredibly good news. An economy at 3.7% unemployment is an economy in which anybody can find a job easily, and you have to think in terms of that. Then in terms of inflation, so far, so good. We have not quite reached our target inflation of 2%, but we are very close. From that point of view, things are good.

The last thing is this. Sometimes recoveries are very unhealthy. You have the housing sector ahead of every other sector, and then you know it is going to turn bad at some point. Here, it is not the case. It is one of the most balanced recoveries that we have had in the history of the US. All the sectors are going the right way, be they consumption, investment, and housing investment. It does not portend its own downside fate. There is no sector which is out of sync and on the verge of collapsing.

This is where the news is best, but if you look at Europe, it is also good news. The growth has slowed down a little bit in the last three months. However, if you look, it is now a part of the world which is recovering. The difference with the US is that they are not at full employment. It is clear that, on that front, they have some way to go. There is news to come from Germany. As you know, the unemployment rate in Germany is as low as it is now in the US, and this was unexpected. We thought we would see inflation in Germany earlier. People who want more inflation are disappointed, but people like me who like low unemployment are quite happy.

There is a larger lesson here, which is this. For reasons that we may not like, namely that labour is weaker in bargaining, what economists call the equilibrium rate of unemployment, or the natural rate of unemployment, the rate of unemployment at which the economy can function without pressure on inflation, is lower. We see this in the US and we see this in Germany, so the good news is that there is still some way to go before we have to put on the brakes and try to slow down the machine. Obviously, something bad can always happen. However, I can see how Europe continue to recover for a number of years, accommodating monetary policy and accommodating fiscal policy.

One remark on this is that how recoveries go depend very much on the central bank. Sometimes, the central bank gets scared and then tightens too early. The good news is that the ECB, at least under current management, is quite convinced that there is a way to go, so interest rates will remain low for a while and allow the economy to keep recovering. Again, not everything is perfect. I have not mentioned Italy, but I will come back to it in my risk section. In general, if you look at Europe as a whole and the Eurozone, things are better than they have been in a long time.

Going outside, I am not going to give you a description of the 15 regions, but I am just going to mention two. Regarding China, something is clear, and I am talking to an audience with some people who know much more about China than I do. However, this is what I understand from my discussions and my readings. China has slowed down. Growth is not going to 7% and now the official number is 6.5. There is a chance that it will go a bit lower, for the reasons which were discussed this morning.

However, what we can see is that there are measures already being taken by the Chinese government to push spending up. This is either through tax reductions or more lending to small and medium-sized enterprises. My sense is that there is a commitment on the part of China to maintain fairly high growth. I would be very surprised if the growth numbers were terrible in China. Current policies may plant the seeds of something worse later. As we all know, there is too much credit growth in China. They were trying to take care of it. They are going to be a bit more relaxed about doing it. The plan makes sense, but there is a bit of a risk. However, in the next 2-3 years, I do not see any catastrophe.

Finally, in emerging markets, there are some horror stories, and some countries which are doing it poorly. South Africa, for example, is clearly not in good shape and Turkey is fighting a crisis. However, in general, if you look at emerging market countries, despite the negative talk, they are growing at the same rate as they were last year, this year, and in the forecast for next year. This is about 4.7%, according the forecast from the IMF. You see specific problems in specific places, but again, it looks as if we are not on the verge of a major slowdown in emerging markets.

Let me now turn to the risks, leaving aside the geopolitical and the political risks. What are the risks which are inherent, built into the system? There is an argument out there, which is that the expansion in the US has been going on for so long so it has to end soon. It is true that expansions do not go on forever. Every year, there is a chance that something will derail it, but we have strong evidence that there is no ageing effect. The probability that there is a recession in a given year does not seem in any way related to the number of years of expansion before. Expansions do not die of old age. It is difficult for us to accept this as human beings, and, unfortunately, is not the case for us humans, but it looks like this for the economy. It could have been otherwise, but the evidence is very strong against ageing. The fact that the US expansion has been that long is probably not a reason to worry.

There is another general line of thought for those who like to worry, and there are many, which is the so-called Minsky cycle. Many of you may know about Hyman Minsky. He was considered a complete heterodox for a very long time, but he turned out to be quite on the dot. His idea was that we have these credit cycles. If the economy does well for a very long time, risk builds, and then eventually it leads to a crash. He had a nearly mechanical view of it, which is that you cannot avoid it. It is just that you go through credit cycles and they are going to come and go. Some people say 'Maybe this is what is happening, after this very long expansion. Credit is in bad shape, and we are ready for a crash'. I have nothing against the Minsky cycles. They are sometimes relevant, and sometimes, you see a credit bubble and then you know that eventually there will be a crash. However, in the case of the US or the European economies today, I just do not see it.

Let me talk about a number of things that are mentioned. One thing is the levels of debt, and that came up this morning. It is true that if you look at debt to GDP, whether it is private debt from firms, from households, from governments, it has gone up a lot. Is this reason to worry? It is reason for looking at the numbers but not necessarily to worry. How dangerous that is depends on various facts. It depends on who the debtor is, and it is much less of an issue when it is the state than when it is private individuals or firms, because the state can mobilise taxes much more easily than we can mobilise funds.

Then the ratios which actually matter from a conceptual and empirical point of view are debt to assets or debt service to GDP. Namely, you compare stock to stock or flow to flow. If you do this, you worry much less. Debt to assets has gone down, not up, and debt service is relatively low by historical standards. Why is it low? It is because interest rates are low. You may say interest rates will probably increase, which they will, but even if they increase by 100 or 200 basis points, debt service remains tractable and historically in line.

I just do not see any particular reason to worry on that front. To give you examples, US households have steadily deleveraged since 2010. Deleveraged means a decrease in the proportion of debt to assets. US firms, because they have very large cashflows, have also been able to reduce their leverage in general, so this does not worry me.

The worries do not stop there. People say, 'You are not looking at the right things. The risk spreads are very low, too low; this is worrisome'. Some of them are indeed low, the ones which were engineered to be low. Namely the ones which were engineered by the central banks to decrease the price of long maturity assets are low. That is intentional. That is not a catastrophe. However, if you look at assets which are not subject to direct central bank intervention, you see that for example, the credit spreads in general are not unusually low. They are low. They are in the 20% range historically, but this is nothing terribly worrisome.

If we look at the stock market, let me leave aside the last two weeks and come back to it quickly. You can look at the risk premium implied by the prices as they were at the beginning of the year and where they are now. The so-called equity premium, the risk premium, is perfectly in line with history. Another way of seeing this is that given the fact that the risk rates are so low, the fact that the prices structure is very high is not a surprise. When you cannot get money and you cannot get return from bonds, you go into equity and you pay more. There, I think that there is nothing terrible about it.

Are there pockets where we see risks? Yes, there nearly always are, and I will mention two. One is crypto-currencies. Crypto-currencies have fundamental values of zero and I expect most of them will go there very quickly. It would be quite good, because at this stage, it is not linked to the financial system. It is like people playing a lottery. They may get poor, they may lose money, but it is not going to affect the financial system directly. If they were there in 10 years and if they were much bigger, it might, but right now, it is not.

The other I will just mention is the so-called collateralised loan obligation (CLO) market, which has gone a bit too far. There, there is an interesting issue, which is an issue of securitisation. A lot of people came out of the crisis thinking securitisation is a catastrophe. Securitisation as it was done was a catastrophe, but securitisation on its own is a good thing. It proved risks, and if it is done right, it helps. On the CLOs, I am not sure where we are. Bottom line, I cannot get scared. Something can happen, something will happen, but it is not baked in. As always, we have to be very careful about what happened. Let me talk briefly, given that it may be on the minds of some people, about the stock market adjustments.

I do not know now, because the US is not open yet, but as of yesterday, Standard & Poors had decreased by roughly 10%. This was between 5% and 10% in the rest of the world and in some countries more. The question is, when this happens, you always have people say, 'This is the beginning of the end and now it is going to crash'. Then people say, 'No, buy now, because it is going to go up'. I am not going to give you my predictions, which I do not have, but I am going to give you my interpretation.

There are two hypotheses for what may have triggered the (small) crash. The first one is the anticipation that the strength of the US economy is such that the Fed will not be able to slow it down. It is now growing at about 1% above potential. The job of the Fed is to slow the economy down so we do not get to too low an unemployment rate, which would lead to higher inflation, and eventually become an issue. There is a number of people who think that might the explanation. What you saw a few weeks back is that, when the Fed indicated that the economy was indeed very strong, long interest rates went up and the stock market went down. When you have higher longer rates, you have the bond markets doing badly and the stock markets doing badly.

In the last week however, this has not been the case. There have been days in which both the stock market was coming down and the bond yields were coming down, which is inconsistent with that kind of story. This reflects the notion that maybe the economy is slowing down. Maybe it reflects the uncertainty about geopolitics, but it is a different type of animal. In general, my impression is that the stock market was more or less correctly valued as of the beginning of the year. There has not been a whole set of good news since then, not bad news and not good news. At this stage, and I know the risks you take when you see things like this. I think this maybe a healthy adjustment rather than the beginning of the end, but as always, sometimes one is proven wrong.

Let me turn to one more point about economic risks. As I said, I do not think that there has been a lot of risk built up which has to lead to catastrophes. I do not think the expansion will die on its own. However, one main risk which has been discussed relates to what I just said. This is that the US economy is now doing well and is growing in a very strong way. The Fed thinks that it can slow it down, so that unemployment does not go below say 3.5%, and they can do this with the current set of expected rises in rates.

There is a good chance that they will find that they will actually have a much harder time using the brakes to slow down the machine. Maybe they are right, and if there was another 10-20% decrease in the stock market, this would probably decrease demand and do the job for them. However, there is a genuine chance that markets are too optimistic about how flat the yield curve is, and it may move up a lot. If it does, then anybody who is long is going to lose money, and emerging markets in particular may have a hard time, to the extent that they have dollar debt, and some of them do. I do not see this as an enormous risk. Even if it happened, most players could handle it, but in the set of risks regarding economic factors, this would be number one.

In the last five minutes, let me turn to politics and geopolitics. Here, it needs expertise in many fields, which this audience collectively has, but which I do not have, so I may say things which are not right. The first one is the rise of populism, and that is a scary trend which will most likely continue. The question is, what about the short run? Here, there is an interesting thing. Populism has happened before, and it used to be nearly the rule in Latin America for a long time. The populists promised everything to everybody, and then tried to deliver by being totally fiscally irresponsible.

What would happen is that they would have very large budget deficits, and this would lead to inflation and hyper-inflation. They would typically lose power when inflation became very high and people became unhappy enough. We are seeing something quite different. If I look at Hungary and Poland, in both cases, it is clearly populism, but it is very fiscally responsible. We have a different type of populism, which is not more pleasant, but it is less dangerous from an economic point of view. I just do not see Hungary doing anything crazy in terms of macro which would lead to enormous problems. I will come back to Italy later.

Regarding trade wars, we discussed trade this morning, and it is clear that it is disrupting the life of many firms and some of the speakers gave us very concrete examples of what it can do. The problem we have as economists is that we find the mechanical effects of trade war, of the size that seems to be developing, to be not very large. We cannot get a world recession from the mechanical effects of trade tariffs, and we have the sense that we are missing something, that it is our fault, not that the world is really that good.

One way that we get bigger effects than the mechanical effects is when we take into account the policy uncertainty created by the policy discussions about trade tariffs. Firms have to guess what the tariffs will be in that country and in that part of the world, and what the rules will be. In this case, what you can get a strong adverse effect on investment. You get what is known as the option value of waiting, which is that firms put investment plans on hold, because they do not know where things are going to go. They do not know whether the tariff is going to be here or there. If you intend to build the plants, you would rather wait until you know. That is the channel through which trade wars can have very big effects in the short run. They also have big effects in the long run. They affect growth, they affect productivity, but in the short run, that is the effect.

There was an interesting simulation at the IMF, which was in the last World Economic Report, in which they tried to look at different degrees of trade wars and the effect on activity. The first one was the tariffs as now presented by the Trump administration. There are serious tariffs on China and serious tariffs on some goods imported into the US. Then there are various additional levels. The fourth level allows for an effect on investment, and the fifth allows for financial sector distortions.

I am going to give you the numbers, because it gives you a sense of where the economists are. If you just look at the mechanical effects of the trade wars, then the decrease in US GDP was 0.1%. It is not nothing, but not enormous. The effect on China was -0.4%, again, not nothing, but not the end of the world. If, however, you added all the additional elements, the psychological elements, the delay in investment and so on, then you got nearly 1% less for the US and 1.6% less for China. A lot of the issue is going to depend not so much on the trade part but on the uncertainty part in how it affects investment. What we have to watch out for is investment.

Let me end briefly with specific issues regarding specific countries. Regarding Italy, I came out this morning with a piece on Italy, and I will just say what it said. There is a fundamental incompatibility between fiscally irresponsible populist government and the Euro. It just cannot work. If such a government decides to embark on the fiscal expansion which looks dangerous, then it is going to face what was known in Latin America as a sudden stop. Both the domestic investors and the foreign investors are going to try to take as much of their money out as fast as they can.

If they think there is the slightest possibility that Italy gets out of the euro, they will move enormous amounts. Why does it matter? Within the euro, the size of the gross liabilities of a country like Italy is gigantic. It is far beyond what anybody could replace if even in the small proportion of liabilities tried to get out. The ECB cannot do it, the ESM cannot do it, and the IMF cannot do it. As soon as the investors become convinced that it is better to put your money somewhere else, there is nothing which can be done except declare a bank holiday to limit it, and exit the euro and depreciate, to stop the outflow.

Then you re-open on the Monday, with the lira or whatever currency it is that you want to have, but outside of the euro. I am not saying that the Italian government wants to do it. They do not want to do it, but it is not the issue. It may happen to them, whether they want to do it or not. It does not just apply just to Italy, but it applies to any member of the euro. That is a very dangerous thing. I had a few more points, but I have been talking too long.

On Brexit, I heard the speaker this morning, Mr. de Castelbajac, and it is clear that it is going to complicate life and it is clear that it has medium-run issues. What is it going to do in the next few years? That is where the uncertainty is absolutely central. When Brexit was voted in, I thought that most firms would just put plans on hold to see how it went and investment would decline strongly. It did not for a while, but now it does. Now, it is starting to have a very serious effect on investment. As long as the smoke has not disappeared, then there will be very low investment. My sense is that a lower growth in the UK in the short term is the most likely outcome.

There is a last thing I will mention. It is oil. It is clear. We have learned two things from past experience. First about the supply of oil, and, again, I am talking to some people in the audience who know much more about oil than I do. The supply of oil is now largely determined in the medium run cost of U.S. shale oil, which can be produced profitably at

USD 60-70. In the long run, the price probably cannot get above that, and it may, as technology improves, confront a lower and lower ceiling.

However, in the short run, it takes just 1 million barrels less out of more or less 80 million a day to lead to a very big shift in prices. It is fairly easy to think of Saudi Arabia cutting production if it becomes unhappy, or Iran putting mines in the Strait of Hormuz to slow down traffic. There are many scenarios you can think about which would get the price of oil to above 100. That is a genuine possibility. Most economies are in much better shape to handle it. The US in particular can handle it much better than in the '70s, because it produces such a large amount of oil now. However, that would be an issue that we have to think about.

Let me conclude. I do not know how I sounded. I feel that I am less pessimistic than some. At the IMF meetings in Bali, people were extremely pessimistic, and I am not that at all. I do not think that there is any recession baked into the current numbers. It may come, and it will come in some form at some point. However, there is what as economists we call Knightian uncertainty, which is our inability to fully understand the effects of things that we have not seen before on the geopolitical front. We have to continue to worry.