# OMFIF BULLETIN

*Global Insight on Official Monetary and Financial Institutions*

January 2012

# Beware of grand Asian plans

## Like old blunderbuss, currency unions can backfire

**Meghnad Desai, Chairman, Advisory Board**

**Welcome to a new year and old realities. The air resonates with the harsh trumpet of history. We are witnessing a re-enactment of the Great Depression of the 1930s – and similar helplessness with governments.**

We see the slow, painful denouement of the euro experiment. And we observe stirrings among the Asian economies about a regional monetary co-operation scheme, partly because they are fed up with the dollar's global role. Danger Ahead! There are worrisome similarities between the story of the euro and the new seeds sprouting in the Japan-China and Japan-India swap agreements agreed in December.

Let us hope these moves are just helpful small steps towards harmless goals – and not the beginning of some ambitious Asian monetary saga. The euro has taught us that currency unions should follow political and economic union rather than precede them. Political ambition to outshine the Americans is all very well, but countries should not use a currency union as the weapon. Like an old blunderbuss, it may backfire.

The dollar's strength is not due to what the US fiscal and monetary authorities do or don't do. It is the result of America's private markets and the vigour of its businesses. The country's flexibility, its deep liquid markets and the availability of expert financial services are what makes the dollar attractive. Acquiring that is harder than becoming a nuclear power.

Recall that the euro was a result of European impatience with the US's monetary privilege and fiscal profligacy. After 15 August 1971, when President Nixon ended the Bretton Woods gold-dollar exchange standard, Europeans looked for new international currency fixity. The history of this search through the Werner Plan, the European Monetary System, the Exchange Rate Mechanism and the Maastricht Treaty is well known.

*(continued on page 4 ...)*

## Hildebrand resignation underlines pressures on central banks

The announcement on 9 January that Swiss National Bank president Philipp Hildebrand is resigning over controversial trades by his wife underlines the extraordinary pressures on central banks to conform fully to more rigorous codes of conduct in the wake of the financial crisis. **SEE ARTICLE ON HILDEBRAND ON P.27**

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# Thai tussles

## Central bank debt row

**A special correspondent**

**A stand-off between the Bank of Thailand (BOT) and the Bangkok government about debt liabilities resulting from the 1997 Asian crisis is focusing attention on threats to central banking independence caused by the clouded global economic outlook and greater sensitivity about central banks' roles.**

The central bank and the Government are at loggerheads over responsibility for Baht1.1tn ($34bn) in debt incurred as a result of an official bail-out of banks and financial firms in 1997. The row indicates how central banks around the world, including in the US and Europe, are becoming increasingly exposed to political squabbles as a result of long-lasting effects of financial market upheavals.

The central bank has voiced concern about a draft royal decree to authorise the transfer to the BOT of the debt of the Financial Institutions Development Fund (FIDF), saying it might dampen investor confidence in the central bank.

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# When sorrows come...

## A study in global interdependence

**David Marsh, Co-chairman**

**When sorrows come, they come not in single spies, but in battalions. A year ago, OMFIF produced a special Monthly Bulletin on the euro, in the hope that we could get the matter off our chest, solve the small collection of modestly-taxing outstanding issues, and move on to more constructive matters. A year on (as perhaps we knew all along), the euro's self-inflicted and self-fuelling problems are still with us.**

The January 2012 edition – with contributions from 15 of our now 84-strong Advisory Board – thus deals with the delicious, terrifying matter of world economic interdependence. Please see p.30-31 for the full array of our board which includes new members John Adams, a former Bank of England official who is an expert on China; Paul Betts, the former long-time Financial Times European business correspondent; Trevor Greetham, director of asset allocation at Fidelity Worldwide Investment; and Jack Wigglesworth, former chairman of London futures exchange Liffe.

There is no shortage of issue for our team of commentators. Philipp Hildebrand, the intelligent but over-exposed former president of the Swiss National Bank, has fallen from grace, demonstrating the new pressures on central banks and central bankers around the world. In the wake of December's agreement on swap lines between the central banks of China, Japan and India, Meghnad Desai cautions against Asia developing grandiose monetary plans on the overly ambitious scale of Europe's. We look at the tussle over central banking independence in Thailand, which has deep overtones of similar squabbling in other countries ranging from Hungary to the US.

John Kornblum points to some disquieting parallels between Europe and Russia. Michael Kaimakliotis and Marina Shargorodska write that 'muddle through' will no longer work. 'Daisy-chain bailouts where nearly-bust European governments lend to each other in the hope that their credit quality will magically improve will have to be abandoned.' Gerard Lyons uncovers some grounds for optimism as the balance of world economic activity moves East. Freddy Hopson, whose forecast at the beginning of last year proved uncannily prescient, sees another Year of the Dollar. Darrell Delamaide believes that, as the US economy improves, Barack Obama must be favourite for the November elections.

We have a series of articles on the euro imbroglio. Stefan Bielmeier spells out German conditions for making the euro work. Martin Feldstein says Europe should give up hope of fiscal union and move to country-by-country solutions. Thanos Papasavvas says historical impetus will prevent a euro break-up. John Plender shows how German support for budgetary rectitude predates the Weimar republic. Pawel Kowalewski investigates Europe's difficulty in finding its own identity. Trevor Greetham labels Europe's insistence on more austerity as an economic suicide pact. Paul Betts and Roel Janssen explore euro politics in France and the Netherlands. And we look at a new strand of euro-scepticism (or euro-realism) in Germany with publication of a thoughtful scenario for fragmentation of the euro by the conservative Frankfurter Allgemeine Zeitung newspaper.

We lift our eyes to wider matters, too. John Nugée examines with magisterial sweep the re-emergence of the Political Economy in driving wide-ranging moves to re-regulating the financial sector. Himadri Bhattacharya outlines a new approach for stress-testing central banks. William Keegan opines that the withdrawal of world-wide financial stimulus since 2009 would have J.M. Keynes turning in his grave. Only he points out, helpfully, that the great man was cremated.

David Marsh

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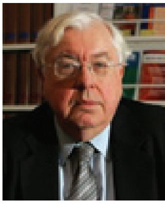

# Putting the past to bed

## EU leaders and Russia's Putin making similar mistakes

**John Kornblum , Advisory Board**

**The year 2012 marks the twentieth anniversary of two momentous events in European history. The collapse of the Soviet Union on 1 January and the Treaty on European Union signed in Maastricht on 7 February. Both events looked forward to a new era. Unfortunately, during the past two decades, both the new European Union and the Russian federation have based their strategies more on the past.**

Europe looked back at the past – at the balance of power politics of the 19th century – as a means of equipping itself for a new age. But it was the wrong century. Europe's leaders should have looked back to the 1500s when Europeans broke all barriers and re-designed the world. The motor then was the decline of the Church and the rise of the ideals of the Reformation. Today, we are experiencing a similar decline of centralised institutions and the lure of new freedoms, this time made possible by technology. These are the challenges. And – underlined by the shortcomings of the euro – Europe is manifestly failing to surmount them.

*In a world of globalised networks where market trades are completed in milliseconds, the institutional and political cultures of both the EU and Russia have become dysfunctional.*

Europe's top-down elitist attempt to impose stability using an inappropriate model is uncannily similar to the efforts made in Russia by Vladimir Putin to impose unity from above on the foundations of the old Soviet Union. When the Soviet Union ended, its empire dissolved into 12 sovereign nations. The Maastricht treaty signed just five weeks later aimed to merge a similar number of nations into one.

The Europeans and Russians both wanted to make something new out of the old structures, They sought in each case a platform for the return to former global influence. Both attempts are ending in failure.

In Europe, just as with the Church in the 16th century, top-down control is losing credibility with normal citizens. Europe is not weak socially or technologically. But its visions were designed for a different era. The old sense of European unity and destiny has now more or less disappeared. Germany in particular is moving away from European structures, not as the old imperial Germany, but as a country that has learned how to keep up with globalisation. For this task, Europe offers Germany very little, except, as Angela Merkel always puts it, fear of itself.

We see similar wrong turnings in the East. Putin's Russia built state capitalism, suppressed freedom of expression and invented various means of both coaxing and disciplining its own population and those of the 'near abroad' to follow its lead. Modernisation and expanded horizons were sacrificed in the name of stability. Oil money kept the engine running for longer than deserved. But, shown by rising anti-Putin opposition, Russia is becoming less unified and less viable with each passing year.

In a world of globalised networks where market trades are completed in milliseconds, the institutional and political cultures of both the EU and Russia have become dysfunctional. As Europe loses credibility, power will migrate steadily to the states, and more dramatically to globalised corporations. Europe's leaders are trying to hold back the deluge by playing to Europe's guilt and shame from the past, resurrecting the hang-ups of past wars. It's as if they're saying: 'If you don't listen to us, you will be bad again.' Yet, ever fewer are receptive to the message.

The Maastricht arrangements were designed essentially to rebuild the institutions of a national state – a common currency, a common defence and a common internal order. Democratic debate was rarely part of the process. When it was, as in France, Denmark and Ireland, the results were embarrassing. The goal was not to innovate for the future but to stave off instability.

*(continued on page 4 ...)*

## Beware of grand Asia plans (... continued from page 1)

The end-result was the euro, launched with much fanfare and great expectations. A strong motivation for Europe's new money was the ambition that it would replace the dollar as the key currency.

Europeans suffer, after all, from visceral anti-Americanism. The single currency was the way to show the Americans that EU had arrived as a superpower and was about to take over. Well, it hasn't quite turned out like that.

We all know the dollar is a problem. This has always been the case. The Americans can issue currency which everyone wants. They take their privilege for granted; and they flagrantly misuse it. But like a harlot who is hated by the Elders but loved by the Youth, the dollar enjoys undimmed popularity with people searching for safe havens in a storm.

The euro's troubles have strengthened the dollar, even though, as worthy Europeans keep telling us, the crisis in the euro area is a sovereign debt crisis, not a currency crisis. But while the Euro may be a means of payment it is neither a unit of account nor a store of value as far as international traders are concerned. Central banks hold euros; but the punters out there in the market rush to the dollar at the slightest perturbation.

If you look at the Asian swap agreements, they are partly motivated out of simple self-interest. Japan, China and India are rivals and neighbours. Their interests collide and conjoin. Japan is the senior partner as far as its membership of G7is concerned. It has a sophisticated financial market and a currency that historically is second only to the dollar. Japan is lending China a helping hand to boost the renminbi's standing on international markets. China is cautious about the speed, but is obviously moving towards full convertibility.

India is having a rough time with its economy. Inflation is still high, growth weak, the current account deficit large. The rupee has depreciated sharply. Japan's help is not selfless, since this will ease its own investment plans in India. Arguably India needs Japan's assistance less than China. The Reserve Bank of India does not peg the rupee nor does it run a dirty float. The rupee is nearer convertibility than the renminbi.

Nothing wrong with self-interest – so long as Asia's plans do not become too grandiose. In their desire to challenge the US currency, Asian monetary authorities mustn't repeat the Europeans' mistake of letting out of the bottle a genie they cannot control.

## Thai tussles (... continued from page 1)

The BOT also believes the disagreement could harm future development of financial institutions. Banking stocks have been under pressure on the Thai stock market as a result of the move.

Central bank defenders say the proposal is tantamount to monetising debt and could end up sparking a run on the baht. Deputy prime minister Kittiratt Na-Ranong, tasked with resolving the imbroglio, has justified the measure as a result of the Government's constrained borrowing leeway caused by economic uncertainties after last year's floods. There are fears of more disruption. Kittiratt pointed to massive funding requirements for rehabilitating the water-management system after the floods. 'We have to beat the clock, as the rainy season will return in May. We must have a clear plan and have the finances ready,' Kittiratt said. The discord takes place against the background of condsiderable public discussion of the roles of goverment agencies in withstanding the possible negative effects of further deterioration in flood defences in the wake of increased rainfall in recent months.

BOT governor Prasarn Trairatworakul pointed to dangers in the proposed authorisation for the Government to use foreign reserves and other central banking assets to repay the debt. The central bank governor said he was worried, too, about plans to empower the BOT to impose additional fees on financial institutions to raise funds for the debt repayment, which he says will burden commercial banks and their clients.

While the government can borrow an additional Baht 2tn before the public debt threshold of 60% of gross domestic product is hit, technically the finance ministry cannot allocate more than 15% of the annual budget to principal and interest repayments.

## Putting the past to bed (... continued from page 3)

For Europe, 2012 will be yet another year of painful economic recession, social unrest and political malaise, but it will also be an inflection point.

The sovereign debt crisis has deepened and widened, bringing the risk of economic and political fragmentation not seen since the Second World War. This poses a challenge which current European structures seem manifestly unlikely to surmount.

This danger would be all the more serious if an America consumed with its own problems and paralysed by fear of China abandons its role as a guarantor of global balance.

The US is fast losing its sense of responsibility as the default power of Eurasia.

But the flip side of any crisis is opportunity. Collapse of existing structures and patterns of thought provide a chance for dynamic evolution across Eurasia.

Europeans need to be liberated from mistrust of themselves. The lessons of history contain positive messages as well as negative. Before Eurasia can join the globalisation train, the past must be put to bed for good. Let's look back to the future of the 16th century, before it's too late.

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# When 'muddle through' stops

## Hum of emerging markets will start to rattle

Michael Kaimakliotis and Marina Shargorodska, Quantum Global

**This will be the year when 'muddle through' doesn't work. With €320bn of bond redemptions due in Italy and €140bn in Spain, either the members of the euro will find a way to share the burdens or the union will break apart. Solutions like forcing banks to buy the debt, or getting other countries like China or the US to pay, will go nowhere. Daisy-chain bailouts where nearly-bust European governments lend to each other in the hope that their credit quality will magically improve will have to be abandoned.**

EU leaders will carry on trying to force change on Europe, without in most cases bothering to get the support of its people. Economies of the world's largest democracies will continue to lag behind those of more autocratic countries. But sometime during 2012 the collective hum of the emerging economies will start to rattle. There will be noise from Argentina and Venezuela where both countries are likely to face crises before the year is out. In Asia, China's command economy will backfire as the property market and bad loans from the 2008-09 stimulus weigh on the banking sector. Russia will suffer following an election that does nothing to boost international confidence.

2012 will be a good year for transparency. 2011 was not. Jean-Claude Juncker, the Luxembourg prime minister, said last spring he sometimes lies to prevent market speculation. There was a lot of economising with the truth in 2011. How many times did financial markets rally in advance of public information on an allegedly new comprehensive solution in Europe? And how many times did such rallies peter out when results failed to impress?

*There was a lot of economising with the truth in 2011. How many times did rallies peter out when attempted solutions for the euro crisis failed to impress?*

Yet this is not a question solely for Europe. In 2012, in the US, the discussion on how the then US Treasury Secretary Hank Paulson behaved in 2008 will continue to prompt debate. And Ben Bernanke will push to increase transparency on monetary policy decision-making. Finally, expect the Occupy movement to reemerge when the weather turns nicer with some more definite ideas for reform and even perhaps some leadership. Now here are our suggestions for New Year resolutions.

**The ECB** Resolve to stop driving while looking in the rear-view mirror. Deflation is your biggest threat now – not inflation. Respond appropriately.

**Global investors** 2012 may be the year of the dollar. The dollar may rise even though long-term interest rates fall further in coming months. Take advantage of the opportunity to flee into currencies with sounder long term fundamentals and eliminate interest rate risk. It won't feel like the right decision at the time but it will pay off handsomely over a five year outlook.

**All investors** Identify the appropriate investment horizon for you /your clients and behave accordingly. Most investors should have medium- to long-term investment horizons but behave as if they have a horizon of one year or less. It is impossible to take rational investment decisions in such a schizophrenic environment. We are looking at investments in Africa and alternative energy for investors with a long-term investment horizon. At the moment, investments in these areas can be financially rewarding and also accomplish something positive for the planet.

**Writers and commentators on financial markets** Remember that 'markets are not alive'. The big bull statue on Wall Street is just a statue. Constant references to the market 'behaving like a wolf pack' or 'punishing governments' are harmful. They seem to indicate a separation between 'them and us'. In fact, markets are a collection of people making decisions. If Italian bond yields reach 7% then it doesn't mean that the market decided to play a game and push Italy into default just for the fun of it.

We leave you with a final thought. It may help you through a difficult year. 'Lower asset prices mean higher returns for our children.'

# West-East shift brings growth

## We shouldn't get blinded by euro-pessimism

**Gerard Lyons, Advisory Board**

**Further evidence of a fragile West and a resilient East will be on plentiful display in 2012. Continued problems in the advanced economies, linked to the debt overhang and the euro crisis, contrast with the positive prospects facing much of the emerging world. The overall picture, despite the dire position in parts of Europe, remains fairly bright. The West's difficulties must not blind us to positive developments in the East.**

*Twice before in the past 150 years the world economy has experienced a similar fundamental shift compared with what we are seeing now. And in both of those periods it saw strong growth.*

The world economy grew 4.3% in 2010 and around 3% in 2011. Expect a further slowdown this year, to around 2.2%. Two factors drove global growth in 2010. One was a sizeable, synchronised and successful policy stimulus, particularly in the West. The other was the strength of emerging economies, which accounted for one-third of global GDP but drove two-thirds of worldwide growth that year.

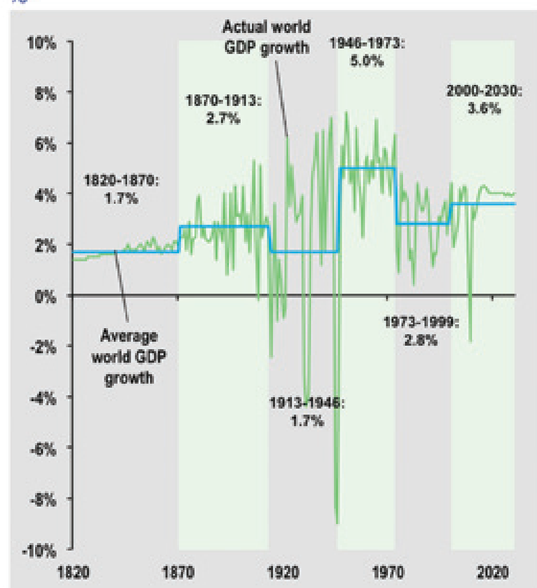
Both of these factors started to unwind as we moved through 2011. Not only did the policy stimulus start to wear off but also a number of economies in the West tightened fiscal policy. Meanwhile, across emerging economies, rising food and energy prices triggered inflation worries and led to significant monetary tightening. As a result, by mid 2011, the world economy had already cooled significantly, triggering fears of a double-dip as the euro crisis unfolded.

It is likely that the euro area, along with the UK, will be in recession during the first half of this year, as austerity bites. Although the US also faces a debt overhang, it is likely to grow this year by around 2%. In the West, the fundamentals are poor, the policy cupboard is almost empty and confidence is fragile. In contrast, across the emerging world the fundamentals are good, the policy cupboard is almost full and confidence is resilient.

No-one is immune to a fall-out from western problems. When the financial crisis hit in 2008, emerging economies were hit by a collapse in global trade and by a loss in confidence. Emerging economies were not decoupled but they proved to be better insulated, because of their high reserves and healthy fiscal positions. They rebounded quickly.

**Shift in the balance of power**

Real world GDP growth since 1820
%

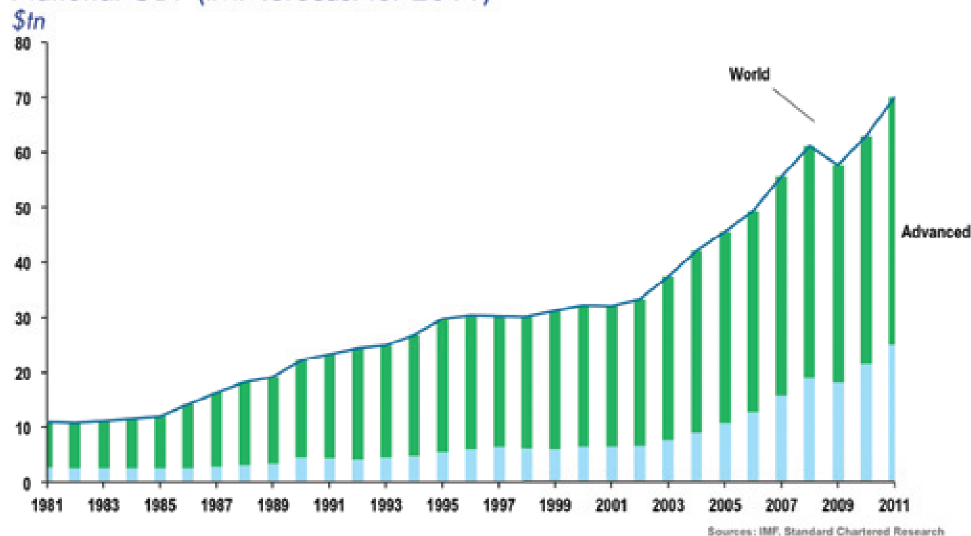



Sources: IMF, Standard Chartered Research

Now, emerging economies are still not decoupled from sluggish growth in the West but they are better diversified, with more resilient domestic demand and also increasing trade flows between emerging regions. What happens in China will be of increasing importance. The economy has already slowed, because of monetary tightening and slower export growth. China will slow further in early 2012, possibly to around 6% growth in the first quarter. But I would then expect policy easing to provide a stimulus, with China returning to 8% growth by the second half of the year.

One should not underestimate the risks in China. The economy is imbalanced, with growth particularly vulnerable to any setback in investment plans. Also, as the Chinese economy has grown in size it has become harder to run from the centre, as in the past. These challenges are considerable.

## The growing share of the emerging economies




In view of other imponderables such as an aging population in coming years, it would not be a surprise if China faced a setback at some stage, but I don't think it will be in 2012. Moreover, when any setback occurs, China has plenty of policy ammunition with which to respond. Thus I remain positive about China.

It is important to stress the fundamental shift that is taking place, not just in China, but across much of the emerging world where the pace and scale of change are dramatic and the catch-up potential is huge. China is experiencing an industrial revolution. Furthermore, the unveiling of its Twelfth Five Year Plan in 2011 shows a desire to move the economy up the value curve. That Plan focused on social welfare, the green economy and on boosting consumption, and it identified seven key strategic industries for future growth.

There are good historical reasons to guard against undue pessimism. Twice before in the past 150 years the world economy has experienced a similar fundamental shift compared with what we are seeing now. And in both of those periods it saw strong growth. The first period was between 1870-1913. Then the world saw the emergence of the US as an economic super-power. Growth over that period was much higher than previously, averaging 2.8% per annum, although it was also volatile. The second, from 1945-72, also brought rapid growth averaging around 5% per year. This period witnessed the emergence of Japan and some of the Asian tigers, as well as the growth of consumer durable markets in the West and a post-war rebound.

One could refer to both of those previous periods as Super-Cycles - a prolonged period of strong growth lasting a generation or more. If so, then one could argue that the world economy is now in its third super-cycle. And that is even after allowing for severe deflationary pressures in the West in coming years.

Despite the financial crisis, the world economy has continued to grow. A decade ago world economic output was $32tn. By the time of the crisis in 2008 the world economy had risen to $62tn. Since then the world economy has grown by 14%, reaching around $70tn by the end of 2011. Some of this post-crisis rise has been explained by inflation but the bulk of it comes from strong growth across the emerging world led by China.

The crisis highlighted not only a systemic failure in some parts of the financial system but also reflected an imbalanced world economy. To address these imbalances requires savers to spend more, deficit countries to spend less and currencies to adjust. Emerging economies clearly have a key part to play. For instance, Asia needs to move from export-led to domestically-driven growth. This requires the growth of social safety nets to discourage high personal savings, help to small and medium-sized firms as they are key to job generation, and the development of domestic bond markets currencies. Change is already happening. Indeed, one change over the last year has been the growth of the offshore Chinese currency market.

The world economy faces major near-term challenges and uncertainties. These should not be underestimated. Yet the longer-term story is a shift in the balance of economic and financial power from the West to the East. And this can and will be a major source of economic expansion. Despite the near-term problems, let us take full advantage of the longer-term potential for higher growth, investment and employment across a more evenly-balanced world economy.

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# Italy can show the way

## Country-by-country fiscal reforms are needed

**Martin Feldstein, Harvard University**

**The initial impetus that led to economic and monetary union (EMU) and the euro was political, not economic. European politicians reasoned that the use of a common currency would instill in their publics a greater sense of belonging to a European community and that the shift of responsibility for monetary policy from national capitals to a single central bank in Frankfurt would signal a shift of political power.**

*Italy has a good chance of persuading investors that it has a favourable long-term budget outlook. Its fiscal deficit is now less than 4% of GDP.*

Historically, the primary political motive behind this was, and may still be, to enhance Europe's role in world affairs. It is against this background that we must view the results of the euro summit in December.

The meeting aimed to find an answer to the single currency's problems. Yet it failed to achieve the increased European political integration that was European leaders' primary goal. Neither did it improve the outlook for euro area sovereign bonds, because those politicians continued to insist that only a fiscal union and political integration could limit the interest rates on sovereign debt.

Indeed, overall, the euro project is an experiment that has failed: the inevitable consequence of imposing a single currency on a very heterogeneous group of countries. The political goal of creating a harmonious Europe has also failed. France and Germany have dictated painful austerity measures as a condition of their financial help. Paris and Berlin have clashed over the role of the European Central Bank and over how the burden of financial assistance will be shared.

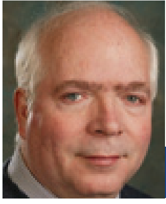
Britain's unwillingness to modify the existing European treaty without additional safeguards means that the new rules agreed in Brussels would apply only to the 17 euro countries and others that wish to join. They don't constitute an official EU treaty and cannot be enforced by the Commission and other EU institutions. So there really is no enforcement mechanism.

Yet Europe's failure to advance the goal of further political integration need not prevent a lowering of interest rates on the sovereign bonds of Italy, Spain and others. Those interest rates can be reduced by individual country policies to bring down current and future budget deficits. Italy has a good chance of persuading investors that it has a favourable long-term budget outlook. Its fiscal deficit is now less than 4% of GDP. Even before the budget tightening by the new government of Mario Monti, the International Monetary Fund projected that Italy would have a balanced budget in 2013.

It's wrong to speak about Greece and Italy in the same breath, as euro area politicians did when they insisted that Greece had to be rescued to prevent a default in Italy. That undermines confidence in Italy. What should be done if global private investors are unwilling to buy the €300bn of Italian bonds that are scheduled to be sold during the next 12 months? Fortunately, only about €40bn are needed to finance the projected budget deficit, while the rest is needed to roll over existing bonds as they come due.

One option would be to go to the IMF, which is already monitoring Italy's fiscal performance. The Fund should be willing to provide the necessary credit without demanding tougher fiscal conditions. Yet if it is not, Italy could cut spending and raise taxes to eliminate the deficit and then repay the maturing debt with new bonds rather than cash. As Italy shows its determination and its ability to reduce future deficits, it should be welcomed back to the capital markets. The French and German leaders need to recognise one fundamental truth. Europe needs country-by-country fiscal reforms, not a renewed push for a fiscal union and political integration.

This article brings together the substance of two recent articles in Foreign Affairs (January 2012) and the Wall Street Journal (15 December 2011). Prof. Feldstein would like to thank the editors of The OMFIF Bulletin for producing this piece.



# US downside from euro woes

## Obama favourite as dollar starts strong

Darrell Delamaide, Board of Contributing Editors

**Barring massive shocks from Europe or Asia, the improving US economy is likely to favour President Barack Obama in the November presidential election. Even if unemployment remains historically high, if the economic trends are in the right direction, Obama should be able to avoid going down in history as a one-term president. News of an unexpected fillip to US employment in December helped give both the dollar and Obama a New Year boost.**

Some of the positive momentum from the latter half of 2011 – improvement in jobs and housing, stronger sales and profit in many sectors, and an uptick in consumer confidence – seems set to continue at least through the beginning of 2012. But forecasts remain cautious, with GDP growth predicted at slightly above 2% for the year as a whole after what is expected to be slightly below 2% for 2011.

Most economists see substantial downside risk, however, with question marks about how severe the universally-expected recession in Europe will be, whether the Chinese economy will have a hard or a soft landing, and whether politics in an election year will play further havoc with the economy. Will the payroll tax cut be extended in February? Will the Bush tax cuts be extended beyond 2012?

Like the US economy, the dollar is expected to continue its positive momentum into 2012, with some forecasters going so far as to predict near parity with the euro. In Asia, meanwhile, much of the tension regarding the dollar-renminbi rate seems to have faded. The December report from the US Treasury about dollar exchange rates found no reason to brand any country a currency manipulator, even though the administration thinks the Chinese currency remains misaligned.

*Much of the tension regarding the dollar-renminbi rate seems to have faded. The December US Treasury report found no reason to brand Beijing a currency manipulator.*

The report cited the appreciation of the renminbi against the dollar since June 2010 – which it put at 12% after correcting for relative inflation – as well as the decline in China's current account surplus and China’s commitments at the G-20 and in bilateral forums to speed up exchange rate flexibility.

There is a hint of a shift to more sternness in future, however. In the light of the ‘persistent misalignment of the RMB at a substantially undervalued level,’ the report continued, ‘Treasury assesses that movement of the RMB to date is insufficient and more progress is needed.’

The US will continue to closely monitor the pace of appreciation while pushing for greater exchange rate flexibility and a sustained shift to domestic-demand led growth, the report concluded.

Reading between the lines, US policy-makers may have concluded that the expected slowdown in China could actually lead to a decline in the renminbi. Flexibility, after all, means going down as well as up.

The economy and the dollar will almost certainly be the focus in the US presidential campaign as it looks increasingly likely that former Massachusetts Governor Mitt Romney will prevail in the primaries and win the Republican nomination. Romney is running on his economic expertise after a successful business career and could prove a tough challenge for Obama, who would prefer to tackle the congressional Republicans, with their fixation on avoiding tax increases in any form.

Romney has been able to don a conservative cloak for the party primaries, but should be able to broaden his appeal to moderate Republicans and independents – and even Democrats disappointed with Obama’s performance – in a general election.

# Another Year of the Dollar

## No substitute for intrinsic strengths

**Frederick Hopson, Advisory Board**

**Those who believe that the euro will ultimately be dismantled see the dollar like the short–term parking zones at airports. As long as you can get out quickly, who cares too much if the architecture and ambience are not perfect?**

Looking back at one's past predictions can be both helpful and painful, especially if one got it wrong for a while. My feeling at the beginning of last year was that the dollar would make a significant comeback during the course of 2011. The forecast – ultimately – turned out to be right. It could be a similar story this year.

Currency bets, contrary to the opinions of many day-traders, are not exactly similar to black against red bets in the casino. It is the final level that determines the outcome of one's game or 'investment' (if one chooses the euphemism of most fund managers).

Last year saw the dollar first decline to unthinkable levels against the Swiss franc and then rebound in such a manner as to make the so called 'safe–haven trade' look like a rollercoaster ride from hell. Anybody selling the dollar at close to SwFr0.70 was able to experience just how quickly one can lose 30% when one bets against the Swiss National Bank. (The SNB chairman, as we now know, favoured dollar purchases at this point.)

Similar experiences have been shared by gold 'investors' who decided that $1,900 was a fair price to be rid of paper currency. The dollar's sudden resurrection meant many hedge fund managers only made money for themselves…an experience that is becoming somewhat irritating to those who entrust their money to 'alternative strategies'.

So what does this all mean? Is the dollar back in fashion as a safe haven or is it just that in this world of fiat currencies one picks the currency that seems least feeble? The answer is probably a mixture of both.

*Is the dollar back as a safe haven or is it just that one picks the currency that seems least feeble? The answer is probably a mixture of both.*

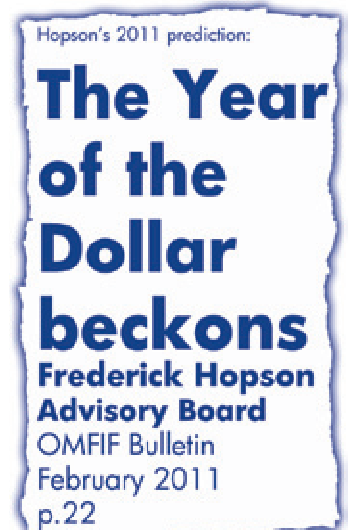
The purchasing power parity of the euro with regard to real assets that real investors buy and sell internationally is reckoned at about $1.20 if one takes Germany as an example, and about $1.00 if one takes Luxembourg.

Peripheral European states probably would probably prefer to have the euro down closer to $1 as it would facilitate their export competitiveness. Euro leaders say they would like to keep the euro (almost as much as the Swiss want to keep the Swiss franc) but nobody has ever said they want to keep it at $1.40! It's the level that counts. A rate closer to parity would not solve the essential problems of the different euro states' highly varying competitiveness, but it would certainly boost German exports and thus allow them to help other needy European states (well a bit at least..)

Such considerations increase uncertainty about whether the current exchange rate constellation is stable. As the realisation sets in that hard assets such as US property can be bought for a fraction of European prices, people who until now have simply shifted their money from Italian and Spanish bonds to German Bunds are starting to move their assets out of the euro area altogether.

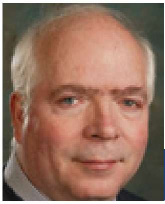
Previous dollar moves have seen very large medium-term swings. From 2000 to 2008 the euro practically doubled in value; remember when the euro was as low as just over $0.80. Downswings have been just as volatile if one looks at a rebased euro chart going back to the 1980s. The euro's fall to $1 would be surprising to many people but is definitely in the realm of possibility, comparable to the dollar's ride up to DM3.40 in 1985.

Obviously nobody would dare to predict it could really happen…


Hopson's 2011 prediction:

**The Year of the Dollar beckons**

**Frederick Hopson**
**Advisory Board**
OMFIF Bulletin
February 2011
p.22



# Something old, something new

## Dovish commitee for 2012

**Darrell Delamaide, Board of Contributing Editors**

**The policy-making Federal Open Market Committee at the Federal Reserve will take on a more dovish cast in the New Year as four different regional chiefs rotate into voting positions starting with the meeting later this month. All members of the Federal Reserve Board of Governors (currently five with two unfilled positions) and all 12 heads of the regional Fed banks take part in the regular monetary policy meetings of the FOMC, but the only ones who vote are the governors, the NY Fed chief and four other regional bank heads in a three-year rotation.**

Sandra Pianalto

### Regional chiefs likely to back Bernanke

The regional chiefs assuming voting duties in 2012 will be more likely to back Fed chairman Ben Bernanke's accommodative tendencies. The new voting members are **Sandra Pianalto** of Cleveland, **John Williams** of San Francisco, and **Dennis Lockhart** of Atlanta – who all rate as doves – and **Jeffrey Lacker** of Richmond, a hawk. By contrast, the 2011 voting members were skewed in the other direction with three hawks – **Charles Plosser** of Philadelphia, **Richard Fisher** of Dallas, and **Narayana Kocherlakota** of Minneapolis – and only one dove, **Charles Evans** of Chicago.

Richard Fisher

### Obama names Democrat, Republican to Fed seats

President Barack Obama in the closing days of 2011 nominated two former Treasury officials to fill the open positions on the Board of Governors. Clearly in the hopes of easing Senate approval, Obama paired a Democrat, Harvard financial economist **Jeremy Stein**, with a Republican, **Jay Powell**, a private equity specialist who worked in Treasury under the first President Bush.

Stein, who has a doctorate from MIT, served as a senior adviser at Treasury during the first few months of the Obama administration and then on the staff of the Council of Economic Advisers. He favours greater regulation for financial stability, including higher capital requirements for banks, but has been sceptical about breaking up big banks or spinning off their securities activities.

Dennis Lockhart

Powell, though a Republican, is decidedly more moderate than the Tea Party conservatives now dominating the party. Just last summer, he co-authored an analysis for the Bipartisan Policy Center that strongly cautioned against a strategy of making an increase in the federal debt ceiling conditional upon a reduction in the deficit.

While board member tenures technically are for 14 years, few actually stay the full term and most appointments are for shorter periods. (Stein's nomination is for a term ending 31 January 2018, while Powell's is set to last to 31 January 2014.)

John Williams

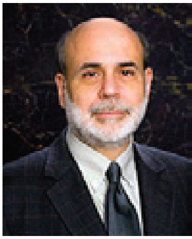
The nominees must be vetted by the Senate Banking Committee and then approved by a vote in the full Senate, if there are no holds or filibusters against them. Sen. Richard Shelby, the ranking Republican on the Banking Committee, for instance, blocked the nomination of Nobel Prize-winning economist Peter Diamond to the Fed board for more than a year by putting a hold on it. Diamond withdrew his nomination last year.

Banking Committee chairman Tim Johnson of South Dakota has pledged to hold hearings on the new nominations soon after Congress resumes on 23 January, but the approval process can take weeks, even if there is no problem. The first FOMC meeting of the year is scheduled for 24-25 January, and the second for 13 March.

Janet Yellen

The term of one of the current governors, **Elizabeth Duke**, who was appointed by President George W. Bush in 2008, is due to expire on 31 January, but she can continue serving until a successor is named. The other board members – **Bernanke**, along with vice chairman **Janet Yellen**, **Daniel Tarullo** and **Sarah Bloom Raskin** – were all appointed or reappointed by Obama.

## Fed officials reassure on European involvement


Ben Bernanke

News of a coordinated central bank effort to keep European banks supplied with dollars during the worsening euro crisis sent top Fed policymakers to Capitol Hill in mid-December to explain that the US central bank was not planning to bail out banks overseas. **Ben Bernanke** met informally with Republican senators and assured them 'he doesn't have the intention or the authority' to bail out European banks or countries, according to lawmakers who participated in the closed-door meeting.

While Bernanke made it clear to the legislators that an economic crisis in Europe would have a harmful impact on the US economy, the Fed has 'no intentions whatsoever' of increasing its involvement, the senators told reporters after the meeting.

Bernanke's remarks came after the Fed and five other central banks announced a half-point cut in the rate for emergency dollar funding through Fed currency swap lines on 30 November. These swap lines, established during the 2008 financial crisis and revived in 2010 with the onset of the euro crisis, supply central bank dollar funding to banks.

While the Fed cannot loan to banks overseas, it can do so indirectly through the European Central Bank and other central banks with the swap lines. The Fed can also lend to US branches of foreign banks through its discount window.

William Dudley

In a more formal appearance before a sub-committee of the House Committee on Oversight and Government Reform in December, New York Fed chief **William Dudley** explained that the easing of terms on the swap borrowing was designed 'to create a credible backstop to -- but not supplant — private markets.'

He emphasised that the Fed participation aimed not just to preserve global financial stability but also specifically to shield economic activity and jobs in the US. 'By reducing the cost of dollar funding via the swap lines last month, we reduced the pressure on banks in Europe to abruptly liquidate their US dollar assets,' Dudley told the panel in prepared remarks. 'Thus, this step will help to insulate US markets from the pressures in Europe and support the availability of credit to US households and businesses.'

*Reducing the cost of dollar funding 'will help to insulate US markets from the pressures in Europe and support the availability of credit to US households and businesses.'*

Dudley echoed Bernanke's comments about limiting further Fed involvement but cautioned that the crisis continues to bear watching: 'At this time, although I do not anticipate further efforts by the Federal Reserve to address the potential spillover effects of Europe on the United States, we will continue to monitor the situation closely.'

## Lacker sees little growth from monetary stimulus

Jeffery Lacker

One of the regional chiefs who takes on voting duties this year, Richmond's **Jeffrey Lacker**, gave a preview when he spoke in mid-December to the Chamber of Commerce in Charlotte, NC, about the economic outlook. He acknowledged that his forecast for 3% growth in 2011 had been overly optimistic, with growth likely to be less than 2%. 'My takeaway from 2011 is the lesson that the impediments to more rapid US growth are likely to be deeper and more persistent than we thought a year ago'.

But this will not lead him to support further monetary easing. For one thing, core inflation doubled – from 0.9% to 1.9% – during 2011, proving that inflation can increase even with high unemployment. The inability of the Fed's monetary measures to overcome the impediments in the economy – particularly the lingering effects of the housing crisis – convinced him that 'monetary policy is often credited with entirely too much influence on real growth,' Lacker said. Despite the Fed's efforts, 'growth has disappointed and inflation has ratcheted upward.' His conclusion: 'Monetary policy is about inflation -- that is, the value of money.' The current deceleration in the rate of inflation is likely to prove transitory, Lacker said, and he still views 'the risks to inflation as tilted to the upside.'

# Why Beijing won't save the West

## China doing what foreigners wanted

**Jonathan Fenby, Board of Contributing Editors**

**Where China is concerned, be careful what you wish for. Until recently, the message for Beijing from the rest of the world was clear. Having escaped the downturn of late 2008 with its big fiscal and monetary stimulus, China had to slow down and bring the economy under control. Not just foreign commentators made the point. Chinese leaders Hu Jintao and Wen Jiabao publicly recognised the lack of balance, coordination and sustainability.**

CPI inflation hit a 37-month high of 6.5% in July. Estimates of local government debt under the stimulus programme started at the audit commission's figure of Rmb11tn ($1.65 tn) and ratcheted up from there. The railways ministry was found to have incurred debts equivalent to hundreds of billions of dollars. A wave of non-performing loans was predicted as a result of the credit boom.

As the jeremiads sounded, the government was, in fact, acting as prescribed. Credit was tightened. Local government finances were put under the microscope. Economic growth came down from double digits in 2010 to 9.7% in the first quarter of 2011 and 9.1%t in the third quarter. Inflation dropped fast. The Purchasing Managers' Index (PMI) hit a 33-month low of 49 in November.

The snag was that this move to a more sustainable course took place just as the rest of the world was worrying about going into a double-dip downturn and looking East for relief. The slowdown on the mainland answers the much-asked question of whether China will save the world economy and, in particular, the euro area. Sorry, but No. President Nicolas Sarkozy emerged from a euro summit in October to announce that he had telephoned Hu Jintao. A mission hurried off to sound out Beijing about buying European bonds. There was never much chance of that happening.

China has no interest in seeing Europe, its biggest trading partner, going into recession. The commerce ministry expects the trade surplus for 2011 to have fallen to $160bn from $183bn in 2010. The drop will continue. But Chinese priorities are domestic, above all re-shaping the economy to move away from the 1980s low labour cost, cheap capital model to move up the value chain, develop technologically and get to grips with the problems of the environment, energy and wealth distribution inherited from the years of go-go growth.

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The outlook for 2012 is for growth to fall to 8% – perhaps up to a point lower if export markets crash. The first quarter will be tough, as Wen acknowledged in early January. After a sharp decline in the later part of 2011, CPI inflation will fall below 4% and may go under 3%. Monetary policy has already shifted towards selective easing.

Measures have been introduced to help medium-sized private exporters hit by a combination of falling external demand, late payment by buyers, rising wages and other added costs. Though there will be temporary hikes in the value of the currency to counter outflows of hot money, the renminbi is likely to be re-pegged to the dollar for the first half of 2012, with fresh appreciation only later. The Government will ramp up the programme to build millions of cheap housing units, not only for social reasons but also to cushion the steel, cement, glass and furniture industries.

There will be wholesale change in the Communist politburo at the Party Congress in October or November followed by the appointment of a new prime minister and government in March 2013. Leaders are focused on getting through the transition in strong shape and moving to the re-balancing objectives of the Five Year Plan. The aim is to provide steadily improving material standards for 1.4bn people. Given the importance of moving in a more sustainable, more balanced and better co-ordinated direction, China's preoccupations in 2012 will be ever more domestic.

# Realpolitik will rescue the euro

## Market pessimism is opportunity

Thanos Papasavvas, Investec Asset Management

**Contrary to the market consensus, I believe neither that the single currency will break up nor that any current member state will depart the euro area. The crisis – 'a terrible thing to waste,' one might say – has some salutary effects. The new Merkel-Weidmann-Draghi axis, composed of the German chancellor and the presidents of the Bundesbank and the European Central Bank, will ensure that the project is re-built with the existing members on more solid and sustainable foundations.**

*The euro will not crumble because the costs and unintended consequences of a break-up far surpass the costs of keeping it together.*

Why will the euro not crumble? Partly because the costs and unintended consequences of a break-up far surpass the costs of keeping it together. Other reasons lie in the positive ideology and historical momentum behind the project. Above all, we should not underestimate the importance of European Realpolitik. Significant political and monetary capital has been invested over the decades in the build-up of the euro. It is primarily a political rather than an economic construct, aimed not only at bringing France and Germany closer together after three wars over 75 years, but also at ensuring different countries' long-term sovereignty and independence. Member states, whether at the centre or the periphery, have strong national interests to ensure they stay united, especially in a changing geo-political environment with new dominant powers rising around the world.

Estonia, Finland and Greece illustrate these over-arching reasons. Estonia's membership owes much to geopolitics, given its proximity to Russia and its past periods of occupation by Sweden, Germany and the Soviet Union. Finland declared independence only in 1917, after more than a century as part of Sweden and Russia. Greece was under the Ottoman Empire for 400 years until it was recognised as an independent nation in 1832. Spain has its own recent past to deal with under Franco, and Ireland its independence from the British less than 100 years ago.

The euro may be too important to fail, but, equally, the creditor nations will not continue paying for inefficient or profligate member states. The German public has already been paying for the reunification of Germany for the past 20 years after the Bundesbank's suggested exchange rate for German monetary union was overruled by Chancellor Kohl.

Germany's longer-term concerns are valid. Creditor nations cannot buy into a system with embedded moral hazards and chronic imbalances. This problem is now finally being addressed through the Merkel-Weidmann-Draghi axis, using a game of brinkmanship we might call 'chickenomics' which puts pressure on politicians to take appropriate action. Tough fiscal policies should be assisted by accommodative monetary policy, similar to the UK's economic policy mix, albeit with the benefit of declining inflationary pressures, which should keep the Bundesbank on side.

The market view of the euro seems split into two camps. In the first category are those who remain unconvinced that the latest rescue plan is any different from politicians' previous attempts. They say the latest patching-up will inevitably come undone, leading to the euro's break-up. This camp is still short the euro, peripheral spreads and underweight risk assets. In the second camp are those slightly less cynical who have been mildly surprised by recent developments but are still waiting to see tangible signs of commitment with relevant treaties changed and/or created. They want to see harmonious implementation of an entirely new construct before they buy into the story. Neither of the two camps is long the single currency, peripheral spreads or risky assets. Those who take the contrarian view stand to profit from an attractive risk/reward framework.

The market exhibits excessive and unwarranted pessimism on the single currency. In my view, the cynical, unconvinced and bearish view on the euro's prospects is completely exaggerated. Europe's history and culture provide a Realpolitik commitment to the single currency and its future that give it huge and often overlooked strengths.

# The moral seeds of strife

## German rule-book may have to be rewritten

John Plender, Board of Contributing Editors

**Germany is pressing for a solution to the euro crisis based on fiscal orthodoxy and financial conservatism. Debt and deficits are punishable offences, regarded as immoral. The usual explanation for this German way of looking at things emphasises the traumatic experience of the 1920s Great Inflation. But there are deeper and older factors at work, demonstrated by the etymological link between debt and guilt in** Schuld.

Fear of currency debasement pre-dates the 20th century. in the Seven Years War Frederick the Great debauched the currency several times to fund the fighting. Note, too, that Goethe's Faust Part II brilliantly describes the perils of inflation. Mephistopheles urges the emperor to use undiscovered gold beneath his lands as putative collateral for promissory notes to pay the army. When the emperor and his court find they can print money without restraint, their wild spending leads to an inflationary spiral and civil chaos.

Goethe served as privy councillor at the court in Weimar. This was an uncanny premonition; Germany had yet to acquire a note-issuing bank when the work was written. Goethe probably drew on experiences of revolutionary France. The National Assembly's issue of assignats – certificates supposedly backed by the value of church properties confiscated in 1790 – ballooned out of control. Goethe's masterpiece no doubt helped embed the anti-inflationary mentality in Germany's educated class. It took the horrors of the First World War and its aftermath – including the special circumstances prompting the Reichsbank to favour note-printing to dull the impact of reparations – to induce the temporary lapse of memory under the Weimar Republic.

*Goethe's Faust no doubt helped embed the anti-inflationary mentality in Germany's educated class. It took the horrors of the First World War and its aftermath to induce the temporary lapse of memory under the Weimar Republic.*

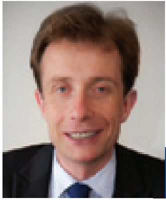
Meanwhile, mercantilism and the fear of sophisticated finance have historically gone hand in hand in Germany and other parts of northern Europe. In the 15th century the cities of the Hanseatic League were profoundly suspicious of credit. They largely excluded foreign bankers. Merchants tried to balance trade bilaterally, relying partly on barter while making some use of coin. The economic historian Raymond de Roover reckoned the League's credit institutions were about two centuries behind the Italians in 1500.

As the 16th century progressed, southern Germans such as the Fugger family became more competitive vis-à-vis the Italians. They developed a system of financial intermediation involving borrowing from wealth-owners everywhere and lending to monarchs. Yet they still mistrusted innovation deeply. German banking continued to lag behind in the 19th century, while in the 20th big German banks were slow to respond to the importance of plastic cards, securitisation and derivatives markets.

Does this conservatism matter? The Germans are superb manufacturers, while the Americans and British happen to have bigger financial sectors. Yet the cultural bias is arguably a disadvantage. A shortage of equity in both banking and the non-financial corporate sector leaves Germany's economy vulnerable to shocks.

The apparent lack of understanding of the reciprocal relationship between debtors and creditors is more damaging. The Germans failed to see that their supposed virtue in running current account surpluses could be upheld only through their trading partners' equal and opposite vices in chalking up deficits. There are also double standards here. The German military was long exempt from financial discipline, and Germany was the first euro member to break the stability and growth pact on deficits and debt.

In the real world, creditors always have the whip hand over debtors. So Germany rules and southern Europe should prepare for austerity, followed by deflation, unemployment and, eventually, civil strife. Whether or not the euro survives, there may have to be a rewriting of the moralistic German rule-book claiming that the only true path to Heaven must be strewn with surpluses.



# It's the mentality, stupid

## Europeans must look to common values

**Pawel Kowalewski, Advisory Board**

**Europeans in a foreign hotel switching on the TV for home news will most likely opt for the BBC rather than Euronews. In Latin America I have witnessed myself that European football supporters rarely support any European team other than their own. 'Anyone but Germany (or England)' is frequently the slogan. Rather than calling ourselves Europeans, should we not consider ourselves merely inhabitants of Europe?**

At the latest European summit in December that came up with yet another plan for resolving the debt crisis, David Cameron, the British prime minister, was cast as the scapegoat for failure to achieve unanimity. But in reality the issues go far deeper. This is not just a quarrel only about money. It's about common values and mentalities. If the Germans are ready (perhaps reluctantly) to pay for Europe, they are far from prepared to compromise on the fundamental questions. Without shared understanding on important matters related to history, culture and religion, it will be almost impossible to draft a common economic policy.

Many inhabitants of Europe love to criticise German policies without bothering to understand what lies behind them. Probably only a few are aware that, in German, the word for debt and guilt is exactly the same. The Protestant ethic along with painful memories of being hit twice by hyperinflation in less than 30 years must have an impact on mentalities. Ignoring this demonstrates myopia or ignorance. Such non-economic factors help explain Germany's well-known reluctance to introduce eurobonds.

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So we need to move beyond economic convergence. It is high time to start thinking about cultural and mental convergence. One can understand notions like economic policy or even common economic policy. But adding the adjective 'European' is more difficult. What does 'European' really mean? Why should Europe be successful in economics when reaching unity has proved near-impossible in other areas? Will a European foreign policy ever be introduced? Latest events in Libya must make us doubtful. And common military action? To restore peace in former Yugoslavia, US intervention was needed. So why, all of a sudden, should Europe be successful in common economic policies?

One cannot deny the success of integration in other areas. Free movement of trade, people and capital has been a triumph. Credit must be given to all the politicians who pushed this forward. Nevertheless Europe is far from being a united entity. It is difficult to disagree with Prof. Harold James who has divided the history of European integration into two periods. The first culminated in the Treaty of Rome, and the second started in the mid-1980s. The first set of accomplishments was less breathtaking in its scope and reach, but proved to be more durable than the more ambitious (and fragile) goals of the second period.

What are the reasons for this lack of sustainability? In spite of all the efforts at integration, inhabitants of Europe still far too often perceive their neighbours as their fiercest competitors rather than partners in European endeavour. We see this particularly in different tax rates in Europe, often used as instruments of competition designed to attract investments at the expense of other countries.

Europe's efforts to diminish large differences in incomes, prices and costs are salutary, but this can only be a lengthy process. Attempts at accelerating the transition will often be counter-productive. Similarly, convergence cannot be viewed only from the perspective of these states that gain subsequent rewards. Germany benefits greatly from the euro, but the bill for establishing and now preserving it has been difficult to accept for many Germans – and is now growing larger. Not only the hard-pressed debtor countries, but also the Germans (and the other creditors) have limited patience and ability to withstand pain. If we understand such truths, integration will proceed, probably more slowly. Failure to understand these issues will halt or even reverse it.

# Fiscal easing is the only way

## Euro fiscal balance pact is economic suicide

**Trevor Greetham, Advisory Board**

**Christine Lagarde, the IMF managing director, has warned of a return of 1930s style protectionism, isolationism and depression if nations fail to work together to counter the escalating financial crisis. Unfortunately, from the perspective of an international investor it seems nations are working together in precisely the wrong direction, with every market panic prompting still more deflationary intervention.**

Defending the sanctity of an inappropriate fixed exchange rate regime and attempting to balance budgets in the face of massive private sector deleveraging were the errors that turned the Great Depression into a self-fuelling downward spiral. It is time to learn from and not repeat the mistakes of history. What the post-bubble world needs is large scale fiscal easing, not austerity. If some countries need to leave the euro to make this work, it should happen sooner rather than later.

*Defending the sanctity of an inappropriate fixed exchange rate regime and attempting to balance budgets in the face of massive private sector deleveraging were the errors that turned the Great Depression into a self-fuelling downward spiral.*

UK chancellor of the exchequer George Osborne is convinced austerity is the answer to what he calls the worsening debt storm gripping Europe. (This is the point made, too, by German chancellor Angela Merkel and Bundesbank president Jens Weidmann in New Year statements.) Rating agencies give UK economic policy their AAA stamp of approval, pointing to the fate of Greece as evidence of the damaging rise in interest rates that lies in store if there is any slippage from the British coalition's tough fiscal retrenchment.

But to make a connection between the plight of peripheral euro nations and the UK is to muddle two separate problems. The first is the familiar balance of payments crisis of a fixed exchange rate regime. The second is a much rarer balance sheet recession characterised by a private sector dead-set on repaying debt irrespective of the rate of interest. In both cases the ratings agencies are wrong. Easier fiscal policy, not austerity, is the only way out.

The Great Depression came about in the first place because countries with locked exchange rates lacked the flexibility to deal with the aftermath of a debt-fueled asset price bubble. The slump in economic activity was made worse by misguided attempts to balance fiscal budgets that had plunged into deficit. In the euro area, these same problems come together today in their most toxic form, making the current policy response tragically self-defeating.

The euro is in a crisis just like that of its forerunner, the exchange rate mechanism, in 1992, or the one a few years later when the US dollar pegs of South East Asia broke down. In those days it was quite normal to see interest rates spike higher as monetary authorities tried to defend overvalued currencies from speculative attack. In the modern day euro area we see a similar effect for slightly different reasons. The 'creditised' sovereign debtors of the periphery cannot restore competitiveness through currency devaluation, nor can they print their own money to repay investors. Defaults are a realistic prospect and long term yields have to rise if they are to attract the capital they need. Economic weakness makes default more likely. The resulting tendency for borrowing costs to increase as growth slows means austerity is doomed to fail.

Any attempt to deflate the South into competitiveness will perpetuate a debt-deflation spiral of falling asset prices, weak growth, rising government bond yields and rising unemployment. In this context the latest proposal to enshrine balanced budget amendments in national constitutions amounts to an economic suicide pact. It should be rejected out of hand. Demands for debt repayments out of proportion with a country's ability to pay call to mind the cataclysmic tensions that built up after the 1919 Treaty of Versailles, the very tensions European integration set out to banish once and for all.

Counter-cyclical fiscal policy is needed more than ever. The ideal way to deal with both the balance of payments and debt problems in the euro area would see the German government borrow money at record low interest rates to finance a boom across Europe.

Spending at home would raise German wages, reducing competitiveness problems for its neighbours while improving the purchasing power of the German consumer. Investing German public money in the periphery would see fiscal transfers replace some of the private sector inflows of the bubble years, allowing for more gradual adjustments. It is easy to see why this suggestion would meet with strong political opposition. However, equally, it is increasingly obvious that the German vision of a euro area of rules-based financial independence isn't sustainable.

*As in the 1930s, the ultimate solution demands a combination of currency devaluations and massive fiscal expansion, in Europe and the developed world as a whole.*

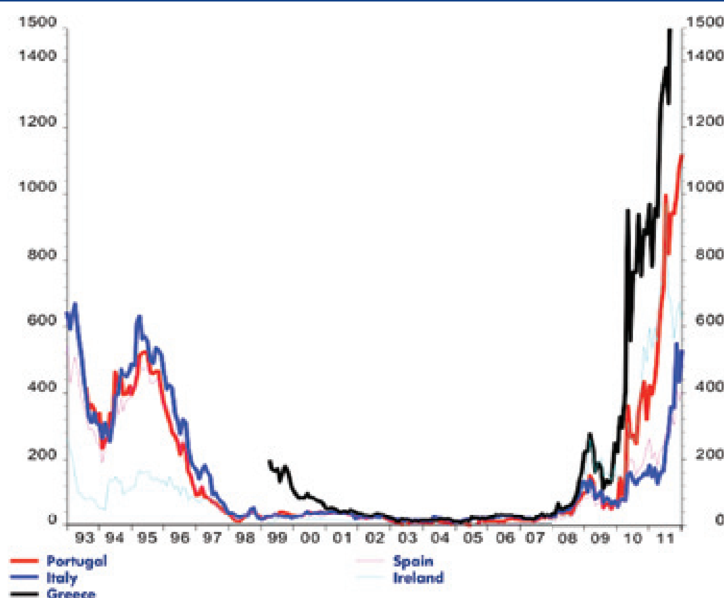
The UK is on the periphery of Europe geographically and, after the Cameron veto, perhaps politically. It is not in the euro and this marks a crucial distinction. Like the US today and Japan post-1990, the UK is suffering from something Richard Koo of the Nomura Research Institute calls a balance sheet recession, triggered by the bursting of a real estate bubble. Base rates will stay near zero and gilt yields will drift lower until the UK consumer has paid off enough debt. Attempts to pay down public sector debt at the same time will merely shrink the economy. With growth weak austerity is failing even against the narrow aims of reducing government debt levels, just as Japan saw in 1997 when prime minister Hashimoto's premature consumption tax hike pushed the economy back into recession.

The conventional wisdom that only central bank action can help us out of this mess is encouraging governments to believe quantitative easing can offset any amount of fiscal drag, but the attempt is like pushing on a string. The only cure for a balance sheet recession is an expansion of government spending to keep the economy moving for as long as it takes for the private sector to pay down its excess debt. The low level of UK and US government bond yields are a signal that the markets would tolerate such an approach.

Unfortunately, maintaining easy fiscal policy in a depression is no mean feat even when inter-state transfers are not involved. As the legendary US economist and Roosevelt administration 'New Dealer' John Kenneth Galbraith witnessed first-hand, premature tightening led to America's painful double dip of 1938. By contrast, recalling a visit to Nazi Germany the same year, Galbraith noted with unease that only authoritarian governments seemed able to sustain stimulus for long enough to get the economy out of its trap.

The bitter truth should be evident to every European policy-maker and every investor. The euro area can only survive as a full transfer union. Those countries that cannot be a part of the new super-state that is needed to make the European currency work should leave the euro and devalue. If the turbulent events of 80 years ago offer a pattern, then the sooner such a step is carried out, the better. As in the 1930s, the ultimate solution demands a combination of currency devaluations and massive fiscal expansion, in Europe and the developed world as a whole. Yes, let us avoid a repeat of the painful mistakes of the past. It takes more than mere cooperation to achieve this. It takes the right cooperation.

**10-year sovereign spreads vs Germany**



# Sarkozy to the front

## President adopts Joan of Arc as electoral ally

**Paul Betts, Advisory Board**

**President Nicolas Sarkozy's New Year hyperactivity suggests he is already in full campaign swing – even though he has yet to announce officially that he is seeking a second mandate.**

The President has been visiting factories threatened with closure or off-shoring. He has launched a new education reform. He has intervened personally to try to rescue the state-run SNCF cross–channel ferry service SeaFrance. He is organising next week what he calls a 'social summit' to address France's record unemployment rate. He is rushing through parliament a so-called social VAT scheme to reduce the heavy burden of French labour charges. He is threatening to impose a 'Tobin tax' on financial transactions in France even if his European partners are still hesitating to adopt a similar measure.

*Sarkozy has decided to gamble on a multitude of fronts to project himself as the candidate best equipped to reform and revive the country.*

He has embraced Joan of Arc as a symbol of his campaign, poaching the heroic French patriot from Marine Le Pen's National Front. And of course, Sarkozy has continued to project himself as the euro's grand troubleshooter in tandem with Angela Merkel. All this activity has inevitably confused even his closest supporters. As one leading banker asked: What does Mr. Sarkozy think Joan of Arc would have done with the euro? The National Front wants to take France out of the single currency and restore the franc. But that is hardly the economic gospel Sarkozy has been preaching of late.

Then there is the question of the Tobin tax. The French financial establishment is up in arms over his proposal to go it alone with this controversial tax if his European partners continue to drag their feet. They have publicly warned that it will simply undermine further the French financial industry and any hope Paris may have had to compete against the City of London. French banks and other institutions will simply move to London or elsewhere the operations that would be hit by the proposed new tax. Such a move, for another leading Paris banker, would be as stupid as imposing a 35-hour working week which is just what the former Socialist government did in an attempt to retain power.

As for the 'social' VAT, that is a good idea that has been knocking around for the past decade and the timing would also be favourable given the current slump in French consumption: in other words the increase in VAT would have only a moderate impact on inflation.

Sarkozy has decided to gamble on a multitude of fronts to project himself as the candidate best equipped to reform and revive the country. He won the 2007 election on the theme of 'rupture' with the past. The rupture has not really happened but then the global crisis sabotaged his grand designs. President Sarkozy has been given credit for his international initiatives, not least after the Lehman collapse and his role in Libya and the Arab Spring. Yet this has had little impact domestically. The French are a pessimistic and introverted people; domestic issues will inevitably dominate the campaign.

Latest opinion polls show Sarkozy is closing the gap with the Socialist François Hollande, until recently the hot favourite. Hollande worries much of the establishment because he has yet to outline a credible programme. But he still has a leading edge because of the growing popularity of François Bayroux, the maverick centrist presidential candidate, the majority of whose voters are likely to vote for Hollande in the second round.

Many analysts originally argued that this election would be won or lost on Europe, the economy and the euro. But signs point to it being a scrappy, dirty domestic affair where personalities will dominate rather than issues. Sarkozy is the most unpopular president of the Fifth Republic. He could still squeak through. But his party could well lose to the Left the parliamentary elections following the presidential vote. France would then be stuck with another 'cohabitation.' That would be the worst outcome not only for the country but also for the euro area.

# April, the cruellest month

## French and German politics diametrically opposed

David Marsh, Co-chairman

**For France and perhaps for the rest of Europe, April – as in the verse of T.S. Eliot – is likely to be 'the cruellest month'. Of the three principal candidates likely to fight the French presidential elections, the first round of which is on 22 April, the most pro-euro contender appears to be, somewhat astoundingly, the incumbent, Nicolas Sarkozy.**

There is a fateful contradiction between the French president and German chancellor Angela Merkel. French and German politics appear to be moving in diametrically opposite directions. The more Sarkozy – himself a strong doubter regarding fundamental issues at the heart of economic and monetary union (EMU) – gives in to German pressure for stronger external controls over the French economy, the less popular he will be in the election battle. Strong French action, urged by the Germans, to bear down on the budget deficit in the face of a rapidly weakening economy will add to Sarkozy's problems with the voters. All of this increases the likelihood that France may shift in coming months towards an overtly nationalistic, anti-euro stance.

On the other hand, the more that Merkel makes concessions towards Sarkozy's electoral sensitivities, in the hope that he remains in power after the second round of the election on 6 May, the more pressure she will herself face from growing euro–scepticism in her own country.

None of this bodes well. Five years ago, as interior minister and former finance minister, Sarkozy revealed his views about the experience of the 'hard franc' which laid the groundwork for France's EMU entry. 'With its exorbitant interest rates and over-valued exchange rate, the monetary policy of the 1990s penalised investment, lowered the competitiveness of French products and French labour, led to an explosion in unemployment and provoked recession. If France had practised the same monetary policies as England at the beginning of the 1990s, then our public debt would not be much more than theirs.'

Sarkozy wrote this at a time when the bitter memory of running the French budget ministry in 1993-95 was still on his mind. After Britain and Italy left the exchange rate mechanism (ERM) in September 1992, and other countries such as Spain and Portugal devalued, France was left with no means of escaping from the triple predicament of high interest rates, an over-valued franc and an economic slowdown – prompting considerable budgetary strains that caused Sarkozy great political pain.

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Like many Frenchmen, Sarkozy saw EMU as the means for France to rescue itself from German domination after Germany's reunification in 1990. Unfortunately, the sacrifice does not yet seem to have brought the promised rewards. As campaigning gets under way for the spring election, both François Hollande, the Socialist challenger, who has made a good start in the opinion polls, and Marine Le Pen, the National Front leader, have declared their hand as highly dubious (to say the least) about the present mix of policies followed by countries within EMU.

Hollande has said he will renegotiate the euro rescue accord reached in Brussels as the pre-Christmas summit. He wants greater powers for the European Central Bank (ECB) and for member states to issue joint eurobonds. Le Pen, daughter of National Front founder Jean-Marie Le Pen, and currently running No. 3 in the opinion polls, has said she would quit EMU altogether.

Beset by high unemployment and low growth, Sarkozy may become the first single-term president of the Fifth Republic since Valéry Giscard d'Estaing in the 1970s. There are already a number of potential flash points, with the Easter weekend earmarked by some as a potential time for Greece to leave the euro and bring back the drachma. The combination of Greek strains and French elections could prove inflammable.

# Summit could lead to recovery

## Italy and Spain still in the most critical situation

**DZ Bank Economic Forecast Table**

| GDP growth | 2011 | 2012 | 2013 |
|---|---|---|---|
| US | 1.7 | 1.7 | 2.0 |
| Japan | -0.7 | 2.0 | 1.3 |
| China | 9.0 | 8.2 | 8.8 |
| Euro area | 1.6 | 0.5 | 0.9 |
| Germany | 3.0 | 1.4 | 1.5 |
| France | 1.7 | 0.7 | 1.1 |
| Italy | 0.8 | -0.5 | 0.0 |
| Spain | 0.6 | -0.5 | 0.2 |
| UK | 0.8 | 0.8 | 0.5 |
| **Addendum** | | | |
| Asia excl. Japan | 7.5 | 7.0 | 7.7 |
| World | 3.7 | 3.4 | 3.7 |
| **Consumer prices (% y/y)** | | | |
| US | 3.2 | 2.3 | 2.6 |
| Japan | -0.3 | 0.0 | 0.1 |
| China | 5.4 | 3.0 | 3.4 |
| Euro area | 2.7 | 2.0 | 2.2 |
| Germany | 2.5 | 1.9 | 2.3 |
| France | 2.2 | 2.1 | 2.2 |
| Italy | 2.9 | 2.2 | 2.3 |
| Spain | 3.0 | 1.5 | 2.1 |
| UK | 4.5 | 2.4 | 2.3 |
| **Current account balance (% of GDP)** | | | |
| US | -3.1 | -3.2 | -3.1 |
| Japan | 2.0 | 2.5 | 2.8 |
| China | 3.6 | 2.7 | 3.3 |
| Euro area | -0.7 | -0.6 | -0.5 |
| Germany | 5.1 | 4.7 | 4.3 |
| France | -2.2 | -2.3 | -2.0 |
| Italy | -3.6 | -3.6 | -3.7 |
| Spain | -4.7 | -4.7 | -4.8 |
| UK | -2.5 | -3.0 | -2.0 |

**Produced in association with DZ Bank group, a partner and supporter of OMFIF**

**The outcome of the December euro summit could constitute a solid foundation for further development of the euro area into a stability union. The decisions put into place the required framework for a gradual easing in coming months of the crisis in capital markets and banking systems.**

Ultimately, politicians seem to have accepted that the crisis cannot be permanently resolved by printing money or shifting debt on to the books of supranational institutions, but only by a clear change of course in the countries concerned.

The leaders' clear commitment to these principles should now make it easier for the European Central Bank to do more to help solve the problem and help stabilise the markets until the day comes when they are completely persuaded that this new strategy is working.

Among the afflicted countries, Italy and Spain are under especially severe pressure to approve and implement additional austerity measures and structural reforms. Both countries need to refinance massive amounts of maturing bonds in coming months.

Their ability to do so appears doubtful at the moment. Our principal forecast scenario assumes that, although uncertainty and heightened risk aversion stemming from the debt crisis will not disappear rapidly, we will begin to see the first signs of a gradual easing of the situation in the course of the first quarter of 2012.

The Brussels decisions are capable of providing the basis for this.

Naturally, however, we cannot rule out a different, more negative evolution.

We have accordingly formulated two risk scenarios, to which we assign a joint probability of around 40%.

Here, the economic consequences would be severe. In the first risk scenario, a market easing fails to materialise in the first half of 2012 and the crisis persists with undiminished force into the second half of the year.

In this case, we see a slight recession in Germany and a still deeper one in the periphery.

In the second risk scenario, we assume a further escalation of the crisis in 2012, leading to a deep and prolonged recession in Germany as well as in the rest of the euro area. In that case, a recovery could hardly be expected before the year 2014.

# Cameron-Rutte alliance falters

## Dutch manoeuvring room constrained by summit

Roel Janssen, Advisory Board

**Ever the optimistic Mr. Nice Guy, Dutch prime minister Mark Rutte went out of his way to present the outcome of the European summit on 9 December as the best possible result. Of course, it was regrettable that Britain used its veto and blocked a new European rescue treaty for the euro but, in the end, the Dutch government wholeheartedly supported the proposals of a fiscal union and semi-automatic sanctions for the euro area.**

The Netherlands teamed up with Germany and France and Rutte stressed his excellent relations with chancellor Angela Merkel and president Nicolas Sarkozy. Yet, for the Dutch, there were obvious disappointments. For three reasons, this will weaken the manoevring room of the second biggest creditor country (after Germany) in the euro area. First, Mark Rutte is an admirer of David Cameron, the British prime minister. Cameron and Rutte are the rare conservatives amid the main European political leaders; all the others are Social Democrats or (increasingly) Christian Democrats. They share not only free market political beliefs, but also energetic self-confidence. After Britain's refusal to agree a treaty change, Rutte has seen the alliance badly attenuated with his closest personal ally in Europe.

Second, the deal reached in December means that the French-German proposals for a fiscal union will be intergovernmental, not at Community level. Historically, the Netherlands has always favoured communitarian solutions in Europe. It is a staunch defender of the European institutions. For example, the Dutch have strongly argued that the new sanction regime for fiscal sinners should be in the hands of the European Commission, out of reach of political peddling in the council of ministers.

The 'Eurocop', a proposal of Rutte and finance minister De Jager late in 2011 for a specially empowered European Comissioner with authority to impose sanctions on errant countries, has gone nowhere. To French delight, any automatic sanction regime has been shelved and the Germans have agreed to that.

Third, in the Netherlands, Rutte has suffered a political setback. His government, a coalition of the Conservative and Christian Democratic parties, does not enjoy a majority in the Dutch parliament. It relies on the support of the PVV anti-immigrant and anti-Muslim party of Geert Willders. But, as the PVV is also fiercely anti-European and opposes any step to rescue the euro area, the government needs the support of other parties for its European policies. So far, only the nationalistic PVV and the leftist Socialist Party (SP) have voted against Dutch participation in the European rescue deals.

This appeals to broad sentiments among the Dutch population and has given both parties strong showings in political polls. The Government, meanwhile, could count on the Social Democrats, Greens and Liberals, all three avowed pro-European parties, to maintain a parliamentary majority for its policies. Now, however, this support is wavering. The Social Democrats reluctantly supported the outcome of the 9 December summit. The Greens decided to withdraw their political support all together, since, in their view, the results were too weak; in their view, the Dutch government should not have settled for an intergovernmental pact of 26 countries, but should have insisted on a Treaty change.

This is ominous, as is shows a growing rift in the Dutch political landscape. On the one hand, nationalistic and anti-European sentiments are pulling the Government towards a more reluctant European policy stance.

On the other, Rutte's coalition depends on the support of pro-European parties that are disgruntled with lack of progress on the euro crisis. For now, the balance is in favour of Rutte's minority coalition. There is sufficient support to approve a €14bn Dutch contribution to the IMF to build up emergency funds to rescue euro countries. But in 2012 Rutte will need all his political dexterity to muster continued support as the crisis deepens further.

*For now, the balance is in favour of Rutte's minority coalition. But in 2012 the prime minister will need all his political dexterity to muster continued support as the crisis deepens further.*

# Thinking about a break-up

## Conservative German newspaper shows change of heart

**Economic and monetary union (EMU) is moving towards an unsettled and potentially destablising period. On the one hand, euro members are shifting towards a credible set of policy measures and financing arrangements to strengthen the currency bloc over the medium term. New leaders have moved into place in three key problem-hit countries, in the form of Mariano Rojoy in Spain, Mario Monti in Italy and Lucas Papademos in Greece, pledged to carry out vital reforms.**

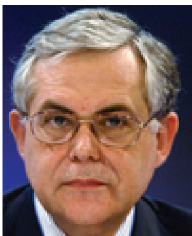
Mariano Rojoy

On the other, the restructuring moves will take time to work through. In the shorter term, lack of growth and doubts by creditors about sustainable financing of the weaker countries' budgetary and current account deficits will feed on each other in possibly destructive fashion. The presidential election in France on 22 April and 6 May, and the parliamentary poll in Greece that looks likely to take place before the Greek Orthodox Easter on 15 April, will bring virulent anti-euro forces to the fore. Such a trend cannot be ruled out in Italy too. French president Nicolas Sarkozy has established a stronger rapport on euro rescue measures with chancellor Angela Merkel in recent months, but he is fighting a Socialist candidate who has promised to renegotiate the December summit accord on fiscal cohesion.

Further belt-tightening in Greece and an agreement with bond-holders on restructuring debt are necessary to trigger fresh bail-out aid in March from the IMF and European Union, without which a departure from the euro is likely. Amid the build-up of pressures, a panel of leading European specialists will be sitting in judgment in February to award the £250,000 Wolfson Prize to the economist who offers the most feasible plan for euro area exit. Among the judges is former Bank of England monetary committee member Prof. Charles Goodhart.

The leading German conservative newspaper Frankfurter Allgemeine Zeitung (FAZ) has taken the project sufficiently seriously to run (in its New Year edition) its own version of a possible entry for the prize. For many years the German media were united in the view that any changes in the composition of the euro were impossible and any flirtation with such an idea was dangerously unrealistic. The FAZ article, reproduced below in an abridged English translation, signals a change of heart in the euro area's biggest economy about a possible radical shake-up of Europe's leading integration project.

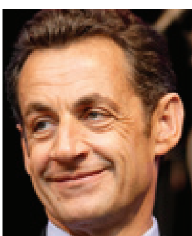
### FAZ prescription for possible euro break-up


Lucas Papademos

**One point is paramount: to be effective, an exit would have to occur without warning. If a Greek plan to return to the drachma were known in advance, people would shift their money from Greek banks to German ones, destabilising banks in both countries. Therefore events need to take place quickly. An opportune time would be a long weekend, for example, from Good Friday to Easter Monday.**

Up to now, the EU treaties do not allow for a country to leave the euro. But this can be changed using the so-called 'simplified treaty amendment procedure', which allows governments to change the rules in the treaty, without the need for all euro area parliaments to vote separately on the matter. This means that if governments decided to bring in an exit clause for the monetary union, then affected countries could make use of it by declaring their wish to quit.

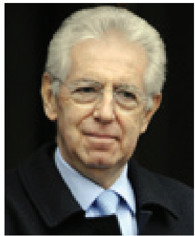
Such legal preparations are essential. Any action must be compatible with EU law to avoid undue costs. Underlined by the experience of the German currency reform of 1948, currency conversions often provide the trigger for expensive litigation. If judges were to see no legally-compliant basis for a euro exit, states would face, in addition to all the other threatened costs, many billions in damage claims.


Nicolas Sarkozy

All EU countries would have to agree the procedure for a simplified treaty amendment. If Germany wanted to leave, achieving such an agreement would be difficult. It would be easier to find an agreement for the withdrawal of the periphery – or for the complete abolition of the euro. Action by Greece to leave by itself would probably not work, on the grounds that it would be too risky; there would be no confidence that the smaller monetary union would be durable. A more tenable solution might therefore be to bring about a separate currency bloc, for example in the form of a 'northern euro'.

After announcement that certain countries were leaving the euro, member states would have to announce temporary restraints on free capital movements. Cross-border payments would be suspended until bank accounts had been converted and new exchange rates established. That could be a relatively quick procedure.

The biggest practical problem would concern cash. EU citizens would try to shift as many euro banknotes as possible from the peripheral states into the strong countries in order to secure stocks of stronger currencies. To prevent this, controls would have to be initiated to enable only small amounts of cash to be carried across borders. That would be inconvenient for travellers. Long queues would be formed at crossing points to allow border officials to examine suitcases and people to search for hidden banknotes.


Mario Monti

The controls would need to remain in force until German banknotes could be distinguished from Greek ones. New banknotes would be needed, which could be supplied from Switzerland under conditions of speed and secrecy.

Central bankers could use complete sets of new banknotes stored for emergencies, similar to the substitute currency stockpiled by the Bundesbank during the Cold War, when there was a fear that the eastern bloc would flood West Germany with counterfeit bills.

In the euro area, central banks say such currency stocks are no longer in existence, raising the alternative that they would have to be brought in from abroad or supplied by adapting existing banknotes with forgery-proof stamps.

The period for exchanging banknotes would have to be far shorter than when the euro was introduced, only around three weeks. Germany would need new notes, too, even if the country kept the euro. Otherwise, the Greeks would hoard their banknotes until border controls ended and then bring them to Germany. If euro departures were limited to Greece, this would be manageable, but not if several countries left, which would require distributing new notes across the euro area.

Simon Wolfson

Automatic telling machines as presently configured would not function initially with the new notes. This would be acceptable since large transactions are now largely paid by card. Converting debit cards into the new currency would be again quite simple. Each country could start with a one-to-one exchange rate for the new currency.

A greater problem would surround the need for flexible exchange rates between the new currencies. The German currency would gain in value, and the Greek one would fall. This would lead to enormous upheavals, with big profits made by some, and losses by others. Distribution of gains and losses would be highly variable. Experts would be required to set detailed rules, depending on jurisdiction of the original contracts.

German companies and banks would lose money, for they have often raised credit in a strong currency. Any assets in peripheral countries would be worth less. The same applies to loans raised through European holding companies based in the Netherlands, since the Dutch currency would tend to rise after any switchover.

Charles Goodhart

This makes the conversion easier to bear for EU citizens whose savings are in funds and insurance companies that are creditors to companies across Europe. But many companies and banks would suffer horrendous losses, because of the mismatch between hard currency debts and soft currency assets.

So huge bailouts would be necessary to save economies from collapse.

Strong countries such as Germany would face great losses because of the funds that have flowed to German banks in past months. These flows have been financed through the Target system run by the central banks. The Bundesbank has built up credits at the other central banks that would lose value enormously.

A look back at history is scarcely encouraging. Monetary unions have been dissolved in recent decades without major frictions only in socialist countries, for example on the break-up of the Soviet Union or Czechoslovakia.

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# New centrality of central bankers

## Hildebrand departure points to wider issues

**David Marsh, Co-chairman**

**There will be those who say that the departure of Philipp Hildebrand as the chairman of the Swiss National Bank was an accident waiting to happen. The curtain has now fallen on an extraordinary combination that will no doubt remain unique: a former hedge fund strategist at the helm of an archetypally stolid institution in one of Europe's most conservative countries. There are plainly lessons here for central banks and central bankers. It is worthwhile spelling out what they are – and what they are not.**

Hildebrand's decision to quit over suspicions of tainted behaviour in foreign exchange dealings is important not because there is any suggestion that the former central banking chief, an intelligent, resourceful, charming man, is a crook. Plainly, he is no such thing. Nor is it significant because bright candidates will be dissuaded from applying for such jobs because of public prurience. One of the less convincing parts in Hildebrand's less-than-humble statements on 9 January was his assertion that people such as himself with 'dollar lifestyles' might in future not be able to become central bankers.

*One of the less convincing parts in Hildebrand's less-than-humble statements on 9 January was his assertion that people such as himself with 'dollar lifestyles' might in future not be able to become central bankers.*

It should be perfectly possible for gifted individuals to hold down senior central banking positions, even though they or their families own investment portfolios denominated in a variety of currencies. They simply need to avoid making large and apparently speculative trades in dollars or other currencies at a time when the central bank is itself considering taking action to influence exactly those exchange rates. Reasonable people should be able to come up with safeguards against this kind of action.

The main lesson from the episode is that it underlines both a new centrality of central bankers and the need for them to acquire skills, expertise and sensitivities to come to terms with this role. As unelected officials who until a few years ago in most cases were paddling unassumingly along little-known backwaters of public life, central bankers have been thrust into the forefront of high-profile decision-making.

In the wake of the financial crisis, partly because governments have run out of more conventional instruments, unorthodox methods for maintaining growth and employment have come to the fore and these are often the preserve of central banks. Through quantitative easing, central banks have crossed the Rubicon between monetary and fiscal policy, invading the space of governments in ways and with repercussions that are not properly understood.

The massive extension of the doctrine of central banking independence, previously the domain of a few self-righteously successful banks such as the Bundesbank (and the Swiss National Bank), raised the need for central banks and their employees to be more transparent and accountable. To safeguard democratic principles, a new framework of appropriate checks and balances is required.

The conspicuous divisions opening up (both within and across countries) between more and less successful performers, between winners and losers, has made public opinion more inquisitive and sensitive with regard to slippage in standards of the public servants who are operating the new instruments. All these means that central bankers have to show almost superhuman probity in all their financial dealings. This, manifestly, Hildebrand did not do. The fall-out in Switzerland and elsewhere will continue unabated.

Hildebrand leaves an intriguing legacy. Of the Swiss National Bank's $250bn in currency reserves as of end-September, 25% was in dollars, 55% in euros, 4% in sterling, 9% in the yen, 3% in the Canadian dollar and 3% in other currencies including the Singapore and Australian dollars, the Swedish and Danish crowns. No less than 9% was in equities. A man who owed his downfall to currency dealing quits a bank that participates in multiple reserve currency management to an extent matched by few other official institutions.

# EMU founders foresaw problems

## Errant states must find own solutions

**Stefan Bielmeier, Advisory Board**

**Some economists argued from the outset that European countries were never fit to abandon flexible exchange rates. This stance reflected an extremely mechanistic reading of optimal currency area theory. Yet the founders of economic and monetary union (EMU) were aware of the potential problems; the euro area's entire rulebook is designed to ensure that EMU can function. The disruptions we are now experiencing mostly stem from failure to comply with the rules.**

It is no longer sufficient to insist that the rules be obeyed in the future. Too much damage has been done in the meantime. We need tighter rules and effective sanctions. The debt and confidence crisis can ultimately be solved only by the countries concerned. But the European Central Bank or International Monetary Fund can act to buy these countries time to implement the necessary austerity measures.

The simplest version of the theory of an optimal currency area states the need for sufficient labour mobility. Migration can act as a relief valve for the stresses that can no longer be offset through changes in exchange rates. But workforce mobility will remain severely constrained in Europe for a very long time. Language barriers alone will see to that.

So how can we achieve acceptably balanced economic and financial developments in a union where neither exchange rate adjustments nor labour migration can compensate for real economic divergences? One solution is a transfer union. This ultimately demands centralised policy-making. But EMU was never intended to be a transfer union. As long as the democratic structures and political institutions needed for central decision-making remain absent, it is preferable to stick with member states' full economic policy sovereignty.

The original solution to imbalances was that all the member countries were obliged to commit themselves to the Maastricht criteria, in other words accept constraints on national fiscal policy and surrender some sovereignty. Those who drafted the euro rulebook erred by making the enforcement sanctions too weak and failing to provide a 'plan B' for persistent offenders. The present crisis demands a correction.

The rules need to toughened, for instance by bringing in automatic borrowing controls (debt brakes) as planned, but also by extending opportunities for external intervention when a country no longer has the capacity by itself to bring its finances back under control. It is essential from the German standpoint that every country must remain subject to powerful incentives to prioritise stability. The high interest rates that over-borrowed countries have to pay in the bond markets are one example of an effective incentive – and one that accords with the spirit of a currency union, not a transfer union.

Germany's rejection of the euro bonds option has to be seen in the same light, though the issue does not appear to have been fully decided yet. A differentiated concept could well offer a practical way to combine solidarity with incentives to optimise national economic policies. Countries would borrow that portion of their funding requirement over 60% of GDP by issuing national bonds not covered by any joint guarantee.

The euro area has in fact transformed itself into an informal transfer union, in that the stronger countries are supporting the weaker ones through payments and guarantees of different kinds. It will not be possible to eliminate this mutual support, but policy-makers should develop clear rules and mechanisms to govern the process, instead of being driven by events to take emergency action – as was the case in the last months. The immediate crisis is not yet contained, let alone resolved. The solution to current problems must come from the countries at the centre of the debt crisis. Italy's recently approved package of consolidation measures is a good example. Emergency aid from the ECB or IMF cannot rebuild confidence. Solutions can come solely from the member countries themselves.

*The high interest rates that over-borrowed countries have to pay in the bond markets are one example of an effective incentive – and one that accords with the spirit of a currency union, not a transfer union.*

# Political Economy comeback

## Governments become pro-active agents of change

**John Nugée, Deputy Chairman, Advisory Board**

**The pace of regulatory and legislative activity has if anything increased over the past year. The new EU-wide regulatory bodies that were set up at the start of 2011 – the London-based European Banking Authority (EBA), the Paris-based European Securities and Markets Authority (ESMA), and the Frankfurt-based European Insurance and Occupational Pensions Authority (EIOPA) – have started to drive forward their agendas. In the US, construction and implementation of the various rules specified in the Dodd-Frank Act continues. And at both global and national level, the banking and financial system is responding to regulatory requirements to raise more capital to ensure compliance with tighter supervisory regimes.**

The task the authorities have set themselves is ambitious in the extreme. Their programme of rewriting financial legislation looks even more comprehensive than the only comparable regulation exercise the financial world previously experienced, in the 1930s after the 1929 Wall Street Crash and 1933 Great Depression. We can observe not just a change in the scale and scope of financial regulation, but also a fundamental change in the attitude of governments towards markets and finance itself.

*We observe not just a change in the scale and scope of financial regulation, but also a fundamental change in the attitude of governments towards markets and finance itself.*

The response of the authorities to the crisis in the global financial system in 2007-08 has gone through a number of phases: fire-fighting to stem the collapse, then deep analysis as to what went wrong, and finally action to increase the effectiveness of regulation. This action is not just to repair and restore the financial system and its defences. Increasingly one can detect a much more ambitious agenda to reshape the financial sector completely. In many countries, the authorities are no longer content to act just as managers of risk for stability orientated ends, but are increasingly pro-active agents of change, using regulation to achieve political ends. In other words, the Political Economy has returned.

In view of the scale of the upheaval, this is perhaps not surprising. The financial collapse since 2007 has challenged almost every belief that the developed world held about the place of finance in society and its methods of operation. The task facing the authorities has been not only to restore order to the financial system and shore up its defences against future crises but also to seek to understand how such a crisis could have occurred and whether there was a fundamental flaw in the construction of global finance. Many people, both in government and in society at large, would hold that after such a catastrophic crash, the imperative is to go beyond the reactive operation of repairing and restoring the system in its old form, and instead refashion and rebuild it anew.

This stance of the authorities as pro-active agents of change is a significant departure from the orthodoxy of the period immediately prior to the crash, from say 1986 (after the UK's 'Big Bang' deregulation) to 2007, when regulators largely stood back from markets and on the whole applied a relatively light touch approach.

It is important to realise that it was the two decades before the crash that were historically unusual, not the period since. The years 1989 to 2007 represented a period of dominance by one country – after the collapse of the Soviet Union and before the rise of China, the US was dominant as few countries have ever been in history – and one ideology. The American creed of Freedom, Democracy and Capitalism was largely unchallenged, certainly in the developed world. Belief in Globalisation and Free Markets as self-evidently the best way to run the world's financial system gained almost universal acceptance, led in many cases by the Bretton Woods institutions themselves, the World Bank and the IMF.

The lack of a viable alternative to the Free Markets standard created a dynamic that favoured one particular approach to the exclusion of all others. Left to ourselves, it is human nature to extrapolate: we tend to think in a linear fashion, and there is a common belief that 'if X is good, then more of X is even better'.

But in a world which appears to be non-linear, such linear thinking tends to lead to excesses, overshooting and sub-optimal outcomes. Markets notoriously overshoot, and so, on the evidence of the recent crisis, can ideologies, thereby exposing inherent flaws and failings. The result, as we have seen, is that, mostly unchallenged and left almost entirely to themselves, some financial institutions and their practices ran increasingly out of control, and in 2007-08 the financial system blew up.

*Mostly unchallenged and left almost entirely to themselves, some financial institutions and their practices ran increasingly out of control, and in 2007-08 the financial system blew up.*

Society's response has been characterised by three phases. First, shock and disbelief. Second, anger at the cost of the rescue. Third, desire for action against what many see as an 'immoral industry'. The political class has had no option but to respond to society's feelings and electoral pressures.

As a result the authorities have been seeking to shape events, markets and the financial industry as a whole, and using regulation to achieve political ends rather than merely stability-orientated ones. The attempts in the European Union to control or, in some cases completely outlaw such diverse elements of the markets as the activities of the credit rating agencies, short-selling, high frequency trading, hedge funds, shadow banking and the like go far beyond 'restore and repair', and speak of an agenda radically to change and reshape markets and the way they operate.

The financial sector probably does not yet sufficiently recognise the full extent of this ambition. Initiatives such as the Volcker Rule, which seeks to curtail proprietary trading and sponsoring of 'hedge funds' by banks, and the recommendations of the Independent Commission on Banking in the UK, which recommends that, by early 2019, UK retail banking activities should be ring-fenced into separate subsidiaries, aim at structural changes similar to those made by the US 1933 Glass-Steagall Act. Some government actions and decisions are bound to be controversial; not all will be successful. Some legislation will be hurried and muddled, other elements will have unintended consequences; there is an overall risk of fragmentation of global financial markets and, as a result, regulatory arbitrage. But the financial community is mistaken if it thinks it can resist the broad thrust of government intentions by arguing too precisely about the details.

The first and most obvious consequence of the return of governments as agents of change is that we now see the return of political risk. The risk that unpredictable actions by governments might radically change the outlook for investors and the value of their assets may now be higher in the developed world than in the emerging economies. Many of the latter offer not only better debt dynamics (lower deficits, lower debt to GDP ratios) and credit risk than developed countries, but also more stable politics and lower political risk.

This poses a challenge to investors. Returns on developed country assets are unlikely fully to reflect their increased risk. Indeed, with inflation and national solvency concerns rising, yet monetary policy remaining lax, the risk-return equation on developed nation sovereign bonds does not seem inherently attractive. Thus emerging country sovereign bond markets look increasingly attractive both on an absolute basis and, even more so, on a risk adjusted basis.

A second consequence is that returns on equity in the financial sector will be squeezed, as higher capital and tighter lending conditions reduce the return on core activities and regulatory restrictions reduce the opportunities for proprietary trading. Yet this should not be exaggerated. Returns are likely to remain healthier than the bankers' more strident complaints would suggest, especially when considered on a risk-return basis. However, we will see a decline from the super-cycle of rapid growth and very high profits which the sector enjoyed between 1986 and 2007, driven by financial engineering. This is to be expected: it was not natural for the financial sector – a service sector – to grow at 15% a year nominal for so long while the economy it served grew at 5% a year nominal only.

One consequence for investors is likely to be a decrease in the attractiveness of bank assets, and a re-rating of bank equity. This already appears to be happening, especially in Europe where bank shares are trading at levels compared to book that are a fraction of what they were only 2-3 years ago, let alone before 2007. Another consequence might be a reduction of the role of the banking sector in much of European corporate finance.

When corporates exceed banks in credit quality, they traditionally seek finance directly from capital markets rather than through banking intermediaries. If this comes about European corporate finance will increasingly resemble its US equivalent, with a much larger role for corporate bonds and commercial paper. The European authorities will probably not stand in the way of such a move and, scarred as they are by an over-large and over-fragile banking system, they may even welcome it.

A third consequence of the increased regulation of banks, alas not so beneficial, is that it creates artificial regulatory barriers to entry and exit. A healthy market needs newcomers which bring in new capital and new ideas, and needs also to allow failed institutions to depart. But banking remains an industry where both entry (a new bank) and exit (a failed bank) are extremely rare. The ever more voluminous and onerous corpus of regulatory requirements looks set to remain a huge and growing barrier to entry.

In this sense, it is possible that the more demanding capital requirements in Basel III and European Capital Requirements Directive (CRD IV) will disappoint. They are based on an approach to bank regulation that seeks to make the banking system safe by making each individual banking institution safe.

This has been the standard approach of bank regulators for over 30 years, but increasingly this looks like a self-defeating mantra. A major consequence of tighter regulations and ever higher capital requirements seems to be to make the banking industry more concentrated and inter-connected, with the unfortunate result that, if and when a bank does fail, the knock-on effects on other banks are very large and may bring some of them down too.

The result is an escalation of the problem of banks being Too Big To Fail. Some in the financial sector believe that, rather than trying to make bank failure impossible, it would be better to make it irrelevant, at least to the wider system: a banking system with a much larger number of smaller, less inter-connected members might be more resilient to the failure of any one of its members, and therefore systemically safer. But to enable such a reshaping of the banking industry, the barriers to entry need to be lowered and the possibility of exit (i.e. failure and bankruptcy) needs to be made more real.

One unexpected and unintended consequence of the regulatory response to the crisis – with inevitably increased costs for all – is the negative impact on savings in general and more specifically on accessibility of savings vehicles and pension savings. The low interest and low economic growth environment combined with a significant number of extensive and burdensome new regulatory initiatives will affect the operating cost basis of the financial services industry, including pension funds.

The result is likely to be lower returns on pension savings and a widening of the pension gaps, reluctance by consumers to save given the minimal returns, and a possible reduction in the choice and availability of investment products as firms react to the regulation by reducing the number of products and limiting access to them.

On a more positive note, the advent of more supranational regulation may at last start to address the conundrum of how to regulate a global industry through mostly national rules and with almost exclusively national financial underpinning should institutions fail and need financial support.

At the moment, many at the nation state level are nervous about sharing what they see as national sovereignty. But with governments in much of the developed world showing increased signs of fiscal fragility, the time may be right for them to overcome their concerns and pool resources for the common good. For investors, especially those for example with memories of losses due to the failed banks in Iceland (where the resources of the state were simply inadequate to back-stop their banks, and creditors consequently suffered real loses), this move would indeed be welcome.

But whatever the individual details, the broad message is clear. The Political Economy is back, and this will have repercussions in many areas. All sectors of the financial industry should be prepared for this, because the trend is here to stay.

*The comeback of the Political Economy will have repercussions in many areas. All sectors of the financial industry should be prepared for this, because the trend is here to stay.*

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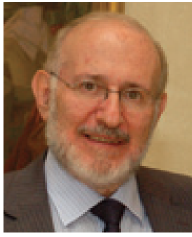
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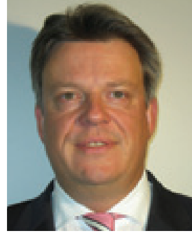
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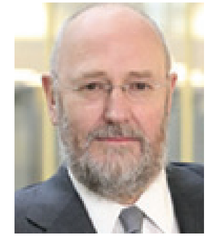
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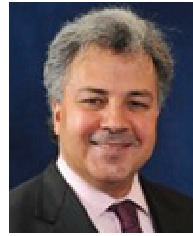
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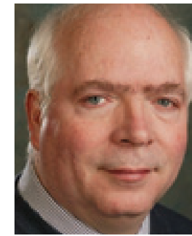
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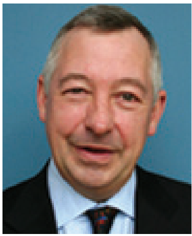
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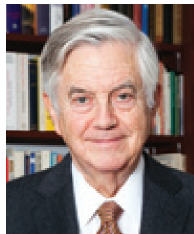
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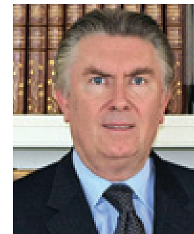
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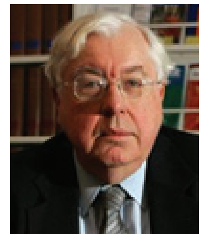
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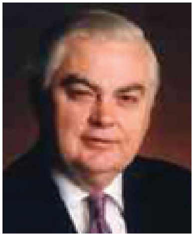
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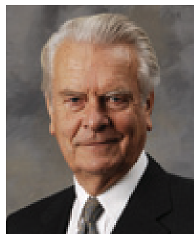
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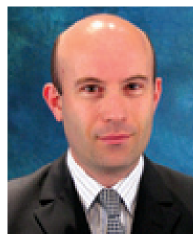
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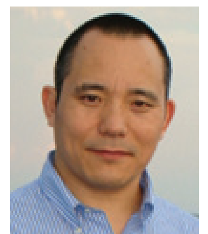
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# Stress testing central banks

## New approach needed for multiple risks

**Himadri Bhattacharya, Former Chief General Manager, Reserve Bank of India**

**As one long-lasting effect of the financial crisis, central banks around the world are exposed to both heightened economic risks and increased political and public scrutiny. In view of these constraints and hazards, a framework is needed for an innovative approach to stress testing central banks. Both the central banks themselves, and the public and private bodies that supervise or monitor them, require analytical tools to improve assessment of potential exposures and outcomes under multiple, possibly simultaneous stresses, and to produce methodologies and solutions to mitigate them.**

Central banks are different from their private sector peers in investment activities, including risk management not least because they need to balance many objectives and issues ranging from broad macro-economic policy goals to micro aspects. These include the definition of portfolio benchmarks.

Their balance sheets can be adversely affected by valuation losses, net operating losses, credit risk events, systemic sudden stops, interest rate shocks, inflation surge, rapid reserves accretion/depletion, currency intervention, contingent liabilities, liquidity crises, and other stresses. Intriguingly, one reason for the large rise in central bank reserves in recent years, concentrated on Asia and other emerging market economies, has been to build up insurance against the risk of disruptive currency movements.

Models are needed that incorporate multiple risk constraints over many periods and at varied times within these periods, linked to multiple strategic objectives like controlling safety, liquidity, returns, and stability. The stress testing may go beyond the balance sheet of the central bank. Depending on the central bank, we extend the balance sheet to the treasury and taxation, for example.

*Models are needed that incorporate multiple risk constraints over many periods and at varied times within these periods, linked to multiple strategic objectives like controlling safety, liquidity, returns, and stability.*

Strong links exist between financial capacity and effective independence. Furthermore there is a negative correlation between financial strength and inflation and that the likelihood of increased inflation can arise from a weak balance sheet. In working out models for stress testing central, an analytical procedure known as 'dynamic stochastic programming' (DSP) – assembling range of linkages between occurrences and outcomes that are affected by a mix of both semi-predictable and random financial and political events and behaviour patterns – is very important.

There are some aspects of DSP that are very important for public institutions. First, public institutions are generally more interested in long-term strategic objectives than short-term profits. Second, the institution has to consider multiple and not single strategic objectives; these can be divided into optimising functions and risk constraints that are easily handled in DSP. Third, the institution must consider the dynamics that are critical in the uncertainty structure because financial and economic regimes are constantly changing over a longer period. Fourth, when institutions go through periods of rapid financial and economic regime changes then correlations, volatility, and price levels and liquidity will be rapidly changing. Fifth, DSP can incorporate stress scenarios into outcome models created based upon the current or projected regime structures.

The classical method for the analysis of stress tests is, first, to develop a baseline and adverse scenario, possibly more than one. The adverse scenario might represent the declining values of, for example, GDP, capital flows, or the ratio of reserves to imports. Associated with that scenario is a multi-dimensional set of results for other variables such as, for example, interest rates, liquidity, the fiscal position, exchange rates, etc. That scenario may be developed through the use of historical data but also with other factors designed to simulate lower probability but higher impact possibilities. Contingency plans can be developed in the event that that scenario might occur, and the results can feed into mitigating the associated risks.

Among the difficulties with this approach is the problem of how to aggregate several scenarios and make a coherent decision based upon all of them. Our framework instead generates a linked 'tree' of stressed scenarios, taking all the scenarios into account at the same time in order to come up with a proposed decision based upon consideration of all possible outcomes.

Second, the classical approach does not allow for 'rebalancing' at various points in the future. If the forward-looking scenario is long enough, say a few years for example, it is unreasonable that as things get worse some intermediate actions would not be taken. But those intermediate actions in the model would have to be taken without knowledge of what the final outcome will be. So the model for generating the scenario cannot consist of one path when rebalancing is done at intermediate times.

Third, the classical approach lacks a decision–variable structure. Within our framework a decision model is developed on top of the scenario structure. The decision model may include, for example, the level of additional capital or liquidity required to inject into the system (institution, aggregate institutions, country, etc.) at several times in the future and based on several contingencies. Since all scenarios and decision variables are considered simultaneously, a probabilistic solution is determined whose values depend upon the probabilities of the extreme scenarios.

Fourth, there are all kinds of risk measures that can be used in the classical approach. However, the classical approach, since it lacks a decision model, cannot incorporate risk measures as constraints. The framework here incorporates all kinds of risk constraints but especially conditional value-at-risk (VaR) constraints that control the tail risk much more effectively than VaR.

These kinds of stress-testing techniques can be applied to public institutions such as sovereign wealth funds and pension funds, including different countries' social security systems. The framework we have developed can address most all the shortfalls of risk management systems and stress-testing methods. It incorporates macro-economic information, financial soundness indicators, composite indicators, and other crisis indicators making it an excellent vehicle to undertake stress tests of changing macro-economic and financial environments.

We believe we can provide an analytical framework to support the central bank in positioning and analysing its balance sheet, including all issues connected to fiscal linkages and subsequent extensions of its balance sheet. This provides the institution with a set of tools that allow it to mitigate the impact of future crises and uncertainties inherent in exit strategies, and maintain overall financial stability. Crucially, the framework we have developed allows mastery of this strategic goal while at the same time meeting the unique set of operating requirements of each central bank.

Himadri Bhattacharya co-authored this article with Jerome Kreuser and Sivaprakasam Sivakumar of the RisKontrol Group. Additional papers and information may be found on http://RisKontroller.com.

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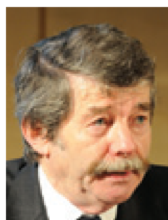

# Snake scotched but not killed

## Keynes would be turning in his grave

**William Keegan, Chairman, Board of Contributing Editors**

**Those of us brought up to believe there could never again be a repetition of the kind of economic disasters associated with the 1930s have had our faith badly shaken in recent years. There was a brief respite in 2009, when the combined weight of the G20 had a dramatic impact on the course of the world economy, with an impressive monetary and fiscal stimulus which stopped the rot.**

Alas, this now appears to have been a false dawn. In Shakespearian terms, the snake was scotched but not killed. Not only was the stimulus withdrawn too soon: policymakers actually threw the gears of economic policy into reverse, with consequences that were visible as economic forecasters celebrated 2012 with predictions of gloom.

The only gleam of light appeared to be a revival of confidence and employment prospects in the US; but even that might well turn out to be shortlived, owing a lot, it seemed, to a brief cessation of Congressional hostilities. Moreover, the avid attention which Washington is paying to developments in the euro area indicates a lack of confidence in the strength of the domestic 'recovery'.

Which brings us to the economic combat zone. There have been many criticisms of Gordon Brown's premiership. But there is one issue on which world leaders and home-grown opponents are prepared to give Brown credit: his leadership in those G20 moves of April 2009. The singular, indeed egregious, achievement of the Cameron administration which entered office in the UK in the summer of 2010 was to abandon the strategy adopted by Brown, and opt for a policy of what has become known, oxymoronically, as 'expansionary fiscal contraction'.

The ring-leader of this perverse approach was not Cameron, who, so far, has devoted little of his time to matters economic, but George Osborne. As chancellor of the exchequer, Osborne not only adopted a policy of highly publicised budgetary cuts when the economy was tentatively recovering from the initial impact of the financial crisis: he also became a cheerleader for this approach, to the world in general, and Continental Europe in particular.

Furthermore, he advocated the kind of deflationary policies that would have made Keynes turn in his grave – I say 'would have' because in fact Keynes was cremated. And he indulged in schoolboyish boasting about how well-founded his policy was. Unfortunately, our rather cocky chancellor was counting his – or our – chickens before they were hatched. He underlined the UK's triple A credit rating, attributing our low borrowing rates in the bond market entirely to his policy. More recently, as the flaws in his strategy have become more apparent, he has given up hope of eliminating the so-called 'structural' deficit within the five year lifetime of the current parliament. Unsurprisingly, Osborne has shown signs of losing his grip.

The first indication of this was when, he rashly cast doubt on the justification for the French economy's high credit rating. This was the opening salvo in an outburst of what might be termed 'verbal protectionism'. It was followed by a Gallic riposte, in which the French prime minister, finance minister and central bank governor all said the UK was in a worse position than France.

The truth is that the UK, France and most of the euro area are in the same boat, implementing 1930s-style deflationary policies, encouraged by the Germans and the British. So far, the resort to protectionism has been restricted to the verbal. But the omens are hardly propitious. I have an uncomfortable feeling, as we enter 2012, that we are on a slippery slope.

## Looking ahead – 2012 diary dates

**Dinner with Gerhard Schröder**
Former Chancellor of Germany
International Statesman's Dinner
7 February 2012, London

**Lecture with Klaas Knot**
President, De Nederlandsche Bank
The Future of EMU
17 February 2012, London

**OMFIF-Banca d'Italia Economists Club**
Roundtable and dinner
27 February 2012, Rome

**Lecture with Ewald Nowotny**
President, Austrian National Bank
Lessons from 1971 for Europe
28 February Lecture, London

**Main meeting with Deutsche Bundesbank**
The World Economy at a Turning Point
14-15 March 2012, Frankfurt

**Meeting with Julia Leung**
Under-secretary, Hong Kong Treasury
The role of London and Hong Kong in RMB internationalisation
20 March 2012, London

**Lecture with Patrick Honohan**
Governor, Central Bank of Ireland
Ireland's experience with EMU
8 May 2012, London

**OMFIF-Bundesbank Economists Club**
Roundtable and dinner
30 May 2012, London

**Word Banking & Finance Summit**
Managing Economic Transformation in a World of Creditors and Debtors
26-27 June 2012, London