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Europe's hopeless capitalism

Two-tier monetary union might be the answer

Meghnad Desai, Chairman, Advisory Board

From summit to summit, the euro area crisis stumbles on. The talk may be of growth but the pact is about zero deficits. Despite all the talk of creating jobs for the young, the euro area offers its people hopeless capitalism for the foreseeable future. Each country is left on its own to achieve a balanced budget. All the help they are promised is a Gauleiter from outside.

The weaker brethren in the South get 20 years of austerity as the prize for staying in the single currency. They face an unsavoury combination of hectoring from the outside, and deprivation of fiscal authority inside their states. Yet they are still saddled with fiscal responsibility.

It's not difficult to work out how they may react. There is every incentive for the weaker countries to break the pact. Greece could seek to do better by leaving the euro, reneging on all its debts, and taking the hit of not being able to borrow for some years.

In return it would depreciate its currency and recover within five years. That would better than the hopeless prospect currently on offer. Contagion may then rescue Portugal and Spain as well from the shackles of the euro area; and maybe Ireland could simply get lucky.

It defies imagination that, when so much economics has been taught in our schools and universities, budget deficits are not defined properly in cyclically-adjusted terms or confined to structural deficits. There is no attempt to plot a feasible path for deficits down from the high level now to zero in a credible fashion. The contradictions stretch to Christine Lagarde, the IMF managing director.

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OMFIF commemorates 20th anniversary of Maastricht signing with Schröder dinner

The 20th anniversary of the signing of the Maastricht treaty on 7 February 1992 is being commemorated with a dinner in London where the principal guest is Gerhard Schröder, the former German chancellor who was in office when the single currency was introduced in 1999. Also featuring in the February 2012 Bulletin are the views of three protagonists at the Maastricht summit, Norman Lamont, Ruud Lubbers and Wim Kok. **SEE MAASTRICHT TREATY 20 YEARS ON, P.6,7,23.**

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Hungarian hubris

IMF victory sends waves

A special correspondent

The trial of strength between Hungary and the international financial community over the status of the National Bank of Hungary has ended in a landmark victory for the forces of central bank independence, sending an important signal around the world. Hungary's climb-down from hubris demonstrates governments that require help from the International Monetary Fund and other official lenders have to conform to acceptable standards of political and economic behaviour.

Hungary's maverick prime minister Viktor Orban has spent the New Year trying to win back trust from the IMF and European Union after his 'anti-austerity, anti-IMF' policies threatened to cut off much-needed official funding.

Orban's centre-right Fidesz party won power in 2010, gaining two-thirds of parliamentary seats and rewriting the constitution in a way that the EU said infringed democratic freedoms and EU laws.

(continued on page 4 ...)

Birthday blues

Last treaty of the Cold War

David Marsh, Co-chairman

John Kornblum, the former US ambassador to Germany who is one of our Advisory Board members, pointed out in the January 2012 OMFIF Bulletin how this year sees the 20th anniversaries of two momentous events: the collapse of the Soviet Union and the signing of the Maastricht treaty. In this special edition, we look at the consequences of the ceremonial accord in the Netherlands on the treaty on economic and monetary union (EMU), which some say was indeed the final treaty of the Cold War.

The Maastricht birthday on 7 February will not be celebrated everywhere with great gusto. It coincides with a special International Statesman's Dinner in London at which OMFIF's guest is Gerhard Schröder, the former German chancellor. Schröder is linked to the history of EMU for three notable and slightly paradoxical reasons.

First, he was a sceptic about the need for and motivations behind the single currency, terming it on one occasion 'a sickly, premature child'. He also pointed out in 1998 how it was likely to enshrine Germany's industrial domination of Europe, because the other countries would no longer be able to devalue.

Second, by presiding over the Agenda 2010 programme of economic reforms during his second term as chancellor, Schröder has helped accelerate the modernisation of German industry in the face of world-wide competition, thus contributing to fulfulment of his 1998 prediction.

Third, in an episode whose denouement is still not clear, Schröder has entered what is shaping up to be a monumental presidential election campaign in France. Still three months away from the second round polling day on 6 May, and before President Nicolas Sarkozy has formally thrown his hat into the ring, Schröder's name has been evoked by both Sarkozy and the Socialist candidate François Hollande as representing the type of economic stewardship that France would like to emulate.

We include in this month's edition contributions to the Maastricht reflections from Meghnad Desai, Norman Lamont, Wim Kok and Ruud Lubbers (the latter two in the form of their interviews for a new book by our advisory board member Roel Janssen). Erik Holm, a former adviser to the Danish prime minister, provides his bitter-sweet analysis on the elusiveness of money as applied to EMU. And we look intensively at the French elections in the form of an interview with Michel Sapin, Hollande's prime economics adviser, and previously unpublished details of an intriguing Franco-German parallel in spring 1981. On the currency front, Michael Kaimakliotis and Marina Shargorodska write that the euro's recent recovery is unlikely to last.

As we keep saying, we mustn't lose sight of the wider picture. Peter Eerdmans outlines the positive outlook for emerging market debt, while Darrell Delamaide and Stefan Bielmeier examine the far-reaching implications of the latest Fed forecast of interest rates remaing low until 2014. Michael Lafferty, Dirk Schoenmaker and Casper de Vries investigate the international dimension of efforts to make banking strictures safer and less expensive to rescue.

Frederik Hopson takes a cynical look at bankers' privileges and bonuses, while William Keegan ends on an acerbic note by again reprimanding David Cameron over his policies towards the rest of Europe. It is good that, in this shifting world, some things remain reassuringly predictable.

David Marsh

Good emerging markets outlook

Exploiting under-invested asset class

Peter Eerdmans, Investec Asset Management

Over the past five years local currency emerging market debt (EMD) has undergone strong development. Although it is still relatively under-owned, the asset class is underpinned by high yields and prospects of currency appreciation. The outlook for local currency EMD for 2012 looks positive, driven by a better outlook for emerging market currencies as inflows pick up and economies accelerate later in the year.

Flows into the asset class have been significant and in some countries foreign ownership of local bonds has increased from virtually zero to as much as 30% of outstanding government bonds. However, even for the early movers, mostly institutional investors in northern Europe, allocations are not fully reflective of emerging market GDP. Many large asset pools have virtually non-existent allocation to local EMD. Interest is increasing from US pension funds and endowments. Similarly, sovereign wealth funds are looking to invest, but have yet to make meaningful allocations. More recently, the EM corporate debt market has started to develop. The EMD sector has been hitherto dominated by issuance of banks and quasi-sovereign institutions. But corporates now have started to look increasingly to international bond markets to finance growth plans.

In terms of opportunities, one must distinguish between opportunities in currencies and those in bond markets. Currencies and bonds behave differently under different economic scenarios. For instance, 2011 saw bonds do well as inflation worries subsided and central banks moved to ease monetary policy, whereas emerging market currencies had a negative year due to global uncertainty and negative investment flows. In local bond markets, yields generally are attractive. The overall yield is currently 6.3%, relatively high compared with the main industrial countries, especially considering emerging markets' better fiscal situation and growth outlook. We expect to see continued rating upgrades in emerging markets, whereas downward pressures will persist in the developed world. Investors in local EMD should at least harness the yield, with potential for additional capital gains.

Two favourable local bond markets are in Latin America. Brazil and Chile may have the most scope for easing monetary policy, largely because their central banks tightened the most in the recent hiking cycles. Brazilian bonds have already rallied over recent months. Further upside is possible since the yield curve is very steep and the central bank seems poised to move the official rate below 10%.

Central and eastern European countries look relatively vulnerable; however, where the fiscal situation looks stable and central banks have room to ease, there is opportunity in bonds. Bonds in the Czech Republic fall into this category and, if we see inflation moderate, potentially in Poland too. In Asia, Indonesia stands out as attractive as inflation seems to have moved lower structurally, demand for bonds is likely to pick up as the country attains full investment grade status, and the central bank supports the bond market. However, after the significant move in yields already seen, we currently prefer a neutral stance.

The part of the market that looks most positive concerns emerging market currencies. Following a very good start to 2012, we expect a positive year. Our view of global economic growth is relatively optimistic. We expect inflows to pick up, more than offsetting modest weakness likely in trade balances. Some of the currencies that performed poorly last year are likely to rebound, such as the Turkish lira, Polish zloty and Indian rupee.

In external sovereign and corporate debt, we also see positive developments. Spreads versus US Treasuries are attractive and offer a good risk/reward balance. Relative to similar rates for their developed counterparts, emerging corporates generally offer a better yield, at the same time as better fundamentals. Leverage is relatively modest in most areas. There is still negative bias from rating agencies for corporates based in emerging markets, offering an opportunity for early adopters of this asset class.

The overall yield for emerging market local currency debt is currently 6.3%, especially attractive considering these countries' better fiscal situation and growth outlook.

Europe's hopeless capitalism *(... continued from page 1)*

Mme Lagarde now cracks the whip for the International Monetary Fund despite a flawed track record in running budget deficits while French finance minister.

What is lacking among the euro members is solidarity. To achieve closer political and economic union, members must demonstrate that pooling sovereignty brings advantages that go beyond external supervision of budgetary plans. It would make sense to have euro-wide taxation to fund fiscal transfers, or even growth- and employment-enhancing schemes across the euro area.

When Keynes formulated his plans for the post-1945 world, he wanted a global bank which would pool surpluses and deficits, tax the surplus countries and transfer money to the deficit countries. Of course, he did not succeed, because the then sole surplus country, the US, rejected the idea. History is repeating itself on the smaller scale of the euro area.

Despite the longer-run aim of an ever closer union, there is no willingness to share surpluses with deficit countries. Protestant morality dictates that surplus countries are virtuous and deficit ones are sinners. Catholicism would allow the sinners to bargain with the Almighty in return for favours, but the euro leadership is, alas, not that accommodating.

Rather than the weaker countries leaving monetary union, a better option would be for them to stay in; instead, the stronger northern members would leave the euro and form a single currency union around a super D-Mark. This way the debt burden of the weaker countries woud not rise in real terms, as it would if they quit. The stronger countries would have an appreciating currency and would automatically yield some of ther surplus to the deficit ones.

This is a fairer and more growth-enhancing option. The European Central Bank would have to manage a double act, but there is no reason why some kind of stabilisation facility should not be allowed to continue for the countries staying in since those leaving don't need any help. If there is no voluntary solidarity, a two-tier exchange rate mechanism may provide a market-driven substitute that would give some hope to countries otherwise facing a hopeless future.

We must hope that common sense will triumph in the face of adversity.

Hungarian hubris *(... continued from page 1)*

In particular, the EU and IMF broke off bail-out talks in December as a result of constitutional changes that compromised the independence of the central bank by merging it with the financial services regulator.

The National Bank of Hungary, which has been involved in a series of tussles with the goverment, denounced the new legislation as 'endangering Hungary's economic stability' and 'seriously harming' the country's interests.

Brussels initiated legal sanctions against Hungary in two other areas concerning the retirement age of judges and the independence of the data protection authority.

In early January IMF managing director Christine Lagarde urged 'tangible steps' to bolster macroeconomic stability in advance of talks on a $20bn to $25bn credit line.

Amid heavy pressure on the forint and on borrowing costs, all three major credit rating agencies downgraded Hungary's debt to junk status.

Following a meeting on 24 January with European Commission president Jose Manuel Barroso, a subdued Orban blamed disagreements on 'technicalities.' Although Orban is trying to save face with his supporters, the dire state of the country's economy gave him little choice but to bow to IMF and EU demands.

The government now says talks on a credit line between Hungary and the IMF and EU will go ahead without preconditions. Budapest hopes to conclude a deal by end-March.

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Norman Lamont is a former UK Chancellor of the Exchequer

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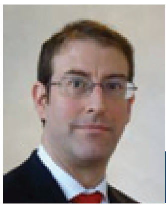

Why dollar will firm

Euro rebound unlikely to last

Michael Kaimakliotis and Marina Shargorodska, Quantum Global

The euro has weakened sharply versus the dollar since April last year when it approached (or even touched) $1.50. But in the week following the Standard & Poor's downgrade of France and eight other euro area countries, the euro rose sharply from near $1.26 immediately after the downgrade to around $1.30 one week later.

Was that the end of trend of the weaker euro? Traders have a maxim: 'Buy on the rumour, sell on the news.' The saying relates to rumours that good news will be announced but it can just as easily be applied to bad news: 'Sell on the rumour, buy on the news'. Indeed, it does appear that sentiment and market positioning are driving the euro-dollar rate. Net open interest in futures on the euro-dollar exploded to reach a short position of 155,195 contracts in the week of the downgrade. That was 30% higher than net shorts had ever been and exceeds the highest net long position ever recorded by 37%.

So it was not surprising to see the euro rise sharply as speculators were forced to cover their shorts as soon as the euro started to rebound. We do not expect however that the euro will strengthen significantly in coming months against the dollar. In order to see why, it's helpful to recall the factors that drove the euro higher through April last year.

First, the Fed was engaged in round two of its quantitative easing programs while there was a pervasive belief that the ECB would follow the German doctrine of central banking and never resort to 'printing' (a view we did not share). Second, the ECB had set interest rates high relative to the near zero rates of the Fed and was expected to hike them up to five times in the coming year. Third, there was better relative economic momentum (thanks primarily to Germany) in Europe.

Fourth were the concerns over the US debt ceiling and the possibility that the US would experience a technical default as well face a downgrade from one of the major ratings agencies. In contrast, today, the ECB balance sheet is increasing faster than that of the Fed and will continue to do so with the next LTRO operation on 28 February and offers of unlimited three year funding to banks (assuming they have the necessary collateral – but the guidelines on collateral have been broadened).

There is also a sense that the ECB is reluctantly willing to purchase government issued securities in large quantities when and if Europe approves and implements a new 'fiscal compact' – though this will take time.

Relative economic momentum has swung decisively in favour of the US which is expected to grow 2% to 3% this year while Europe endures another recession. Interest rates have been cut in Europe. Indeed German Treasury bills now boast negative yields and the 10 year Bund trades with yields 10 basis points lower than the US equivalent. The US was downgraded in August. While this was significant, the event risk has dissipated since it has already taken place. The US debt ceiling meanwhile is not a matter of immediate urgency to investors. Instead the discussion of downgrades, breaches of fiscal targets and debt write-downs now centres on Europe.

One factor which is unlikely to weigh on the euro versus the dollar is central bank activity. Although it has been widely reported that central banks increased the proportion of dollars in their reserves in the third quarter and reduced the proportion of euros, a close inspection of the data reveals that they actually increased their holdings of euros at a rapid pace. The published decline was due only to the 7% fall in the value of the euro versus the dollar.

The trend towards an accumulation of non-dollar reserves is likely to continue apace. Central banks may therefore see the euro's relative weakness as a buying opportunity.

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The memory of Maastricht

Dutch veterans blame casino capitalism

Roel Janssen, Advisory Board

The future of the euro is mired in uncertainty, and capital markets are openly speculating about default by Greece and perhaps other countries, too. Ruud Lubbers and Wim Kok, two veteran Dutch politicians who were closely involved in shaping economic and monetary union (EMU), acknowledge that the treaty setting up EMU had serious flaws, but insist that these shortcomings are not the cause of the current crisis.

'If monetary union fails, Europe as a whole will suffer irreparable damage,' according to Wim Kok.

Twenty years ago, on 7 February 1992, the EMU treaty was signed in the Dutch city of Maastricht where, just two months earlier, treaty negotiations were concluded. As the Netherlands were in charge of the rotating presidency of the European Community in the second half of 1991, these negotiations were chaired by Ruud Lubbers, Dutch prime minister, and Wim Kok, his finance minister.

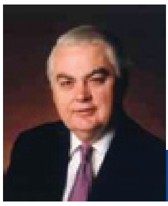
'There was nothing wrong with the treaty', Ruud Lubbers now says in a new book commemorating the 20th anniversary.* 'The huge merit of the treaty is that we decided: "Yes! We are going to do it!"'According to Lubbers, the cause of the EMU havoc has been the rise of 'casino capitalism'. Blaming the euro for the crisis is 'nonsense,' he says. 'Not the euro but unbridled financial markets are the source of the problems. Financial innovations from the mid-1990s onwards, have caused the current drama.'

According to Wim Kok, lack of economic reform and neglect of competitiveness in the southern euro members in the years after the euro's birth in 1999 are 'many times more serious than the flaws of the Maastricht Treaty.' In 1991 Kok chaired the economics and finance minister meetings that shaped the monetary union part of the treaty. He claims now everybody was keenly aware of the risks when diverging national economies were forged into a single monetary system while maintaining economic and fiscal sovereignty. At that time, however, politicians believed these divergences would be resolved and that the sanctions of the Maastricht Treaty – subsequently enhanced with the Stability and Growth Pact – would discipline governments. 'We were insufficiently aware of the vulnerabilities that have come to light in the current crisis. Too long, we underestimated the importance of economic reforms,' he says.

In 1991, according to Kok, there were only two options for Europe. Either the European Community would come to a halt after the completion of the single market. Or it would advance with monetary union, with a common currency, but with leaving fiscal and economic policies at the national levels. Kok says the independence of the European Central Bank was the most important issue at stake during the negotiations. Without it, he stresses, Germany would not have agreed to give up the D-Mark. For a long time, he doubted whether France would accept German and Dutch demands for the ECB's independence.

Regarding the present difficulties, Ruud Lubbers suggests that Wolfgang Schäuble, the German finance minister, should take the same post at the European level, and should be directly responsible to the European Council of government leaders. Together with ECB president Mario Draghi, Schäuble should fix the crisis, Lubbers says. The European Union has no choice but to be actively involved in macro-economic policies of each euro member. 'From the moment you have one currency, you have to deal with each country's fiscal and tax policies', Lubbers insists. According to Wim Kok, to make the euro work, a limited transfer of sovereignty is indispensable. Stronger fiscal policies and economic reforms should pave the way for more active involvement by the ECB. He gives a strong warning of the effects of the euro area's collapse: 'If the monetary union fails, Europe as a whole will suffer irreparable damage. It will hit the entire European project and relationships between European countries will be thrown back dramatically.'

*De Euro: 20 Jaar Na Het Verdrag Van Maastricht, by Roel Janssen, Bezig Bije, Amsterdam



Europe is bigger than the euro

Fiscal union difficult to achieve

Norman Lamont, Advisory Board

When I was Britain's negotiator for the Maastricht treaty, I believed the single currency was impractical. Europe was not an optimal currency area – there was insufficient flexibility of labour. A single interest rate could not accommodate the different monetary conditions and housing markets in different countries. We would lose the possibility of exchange rate adjustment, a necessary tool. Most importantly, I did not believe one could have monetary union without fiscal union, and that was difficult to reconcile with parliamentary democracy.

People speak about the cost of breaking up monetary union but this has to be compared with the costs of sustaining it.

Germany insisted, understandably, that the European Central Bank should be modelled on the Bundesbank and should have the objective only of combating inflation. Germany attached huge important to the no-bail-out clause, which was later shown ineffective with the first bail-out of Greece. But the importance of the no-bail-out principle to Germany explains, to my mind, why Germany at each stage has been doing what critics see as 'the minimum possible' to sustain the single currency.

Critics are sceptical about the EFSF rescue fund and whether it has sufficient resources. They feel that too much emphasis is placed on austerity and that, as with Greece, this has made the situation worse. Italy's prime minister Mario Monti of Italy has warned of the dangers of a popular backlash. Yet we may live under the shadow of a long term crisis. The longer it takes, the greater the risk a major financial institution may fail.

I sympathise with Germany's view of a common bond. A Eurobond would not be the right solution. Bond market convergence throughout the euro area helped to create the crisis. I also agree that the European Central Bank should not be the lender of last resort for governments. Yet there is a suspicion that the ECB's pre-Christmas three-year lending facility for commercial banks results in the latter buying more bonds.

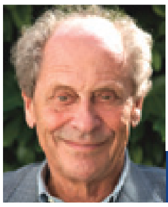
In most currency areas, there is one central bank for one government. In the euro area there are 17 sovereign governments, which can all issue unlimited quantities of bonds. The central bank has to accept them as collateral for the banking system, as if they were risk-free, which we know is a myth.

The euro area has said it will move to a fiscal union. I do not believe we will get a full fiscal union in the literal sense of having a European finance ministry or a common tax system. We may get examination of totals for borrowing and spending and some pre-examination of national budgets. I do not believe this peer pressure will prove very effective.

Although I am opposed to the euro, it would be a disaster if it broke up in a disorderly manner. The euro may get through the immediate crisis but, after that, its geographical contours will have to be re-examined. Currency unions have broken up many times in the 19th century and, more recently, in countries like Czechoslovakia or the rouble zone. There are other parallels with devaluations in Argentina and Iceland. The problems of capital controls and redenominations are not insuperable.

People speak about the cost of breaking up monetary union but this has to be compared with the costs of sustaining it. The guarantees or cash demands that might fall on the German tax-payer could seriously threaten Germany's financial position.

In the long run, I do not believe the euro area will survive. Several euro members are hugely uncompetitive. Deflating themselves into competitiveness will require a very long period of austerity which will not be acceptable to public opinion. The British government would like the euro to overcome its problems because they affect us too. But, if the euro were to fail, I do not think that would be the end of Europe. The euro is not Europe and Europe is not the euro. Europe is much bigger than the euro.



The elusiveness of money

Delors, Daedalus and the Greek drama

Erik Holm, Former Adviser, Danish Prime Minister

The euro crisis threatens to develop into a major disaster for Europe. If that happens, we might ask whether the cause was the crime of the Greeks or the stupidity of the bankers. Yet, if we look at the issue from a historical perspective, it is evident that the crisis is caused, at root, by a lack of understanding of money.

Money is an elusive concept, a fiction, an expectation. It is difficult to manage. It only has real value in the moment it is exchanged for a product or a service. The problems are compounded when, as in the case of the euro, money is founded that is international in character, yet where the instruments of control remain fundamentally national.

This was the case for Economic and monetary union (EMU). It was invented, part of a long line of developments from gold via the Bretton Woods system to the European Monetary System (EMS), to supply an international money to foster economic and political cooperation. Yet the heady hopes have been dashed.

Now the euro divides Europe, and Germany no longer defines its national interest through a unified Europe. Some intended that the euro should challenge the dollar as a reserve currency. But there is a world of difference between the American and the European Union. The dollar is based on a politically unique, strong and dominant economy. The euro manifestly is not.

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What happened was that the Greeks financed their large and growing public deficit with sales of euro-denominated government bonds, backed by the now-infamous credit rating agencies. Greek government bonds could easily be sold on international markets, especially to German and French banks, perhaps at a slightly higher rate of interest than German government bonds.

They were in euro; and a 'Greek' euro had in principle to be as good as a 'German' euro. How stupid can international bankers be?

A euro was, indeed, a euro until February 2010. But then the fiction collapsed. Since then devil has been loose in the streets of Athens. And disagreement, disappointment and ignorance have been running high though endless European Councils.

We may not agree whether this was a crime or a stupidity, but we can at least call it a Greek tragedy. The euro was held in a German-European cage, but could not fly as international money.

It recalls the myth of Icarus, kept prisoner in a tower by King Minos. He was fitted with wings of wax and feathers by his father Daedalus.

Perhaps a forebear of Jacques Delors? When Icarus flew, he lost touch with reality. In his overweening pride he approached the sun. Then the wax joining the wings melted, and he fell into the sea.

The story illustrates the concept of elusiveness, well exemplified by the American economist John Kenneth Galbraith. 'There is nothing about money that cannot be understood by the person of reasonable curiosity, diligence and intelligence,' he wrote in 1975. Yet he qualified the assertion: 'Good monetary policy depends on admitting how much we do not know about the management of money.'

This became truly apparent in the financial crisis that erupted in the US in 2007-08, evolving into a real economic crisis across the Atlantic world. Economists continue to disagree on the means to overcome it.

Small wonder, then, that politicians are perplexed. Those who rely on John Maynard Keynes' theories from the 1930s put emphasis on increasing production and employment through fiscal policy, while others stick to Milton Friedman's and Friedrich Hayek's theories that focus on controlling inflation through monetary policy instruments.

As we have seen during the unfolding of the financial crisis, money is an expression of power. Money provides the means to command society's factors of production, labour, real capital and natural resources. It is an instrument of political leverage, not to say (in the widest sense of the word) a weapon.

Traditionally it has been linked to the sovereign, whose image adorned the coin of the realm. It was 'national' money, before the nation was invented. A large reserve of internationally-accepted money is the first line of defence. Monetary war is a continuation of monetary diplomacy by other means.

International trade needed 'international' money, if it were not to be simple barter exchange. There was a need for something absolute, independent of the nation. A hundred years ago, in the days of the gold standard, the only 'real' money was gold. Taught by bitter experience the Americans and the British sought towards the end of the Second World War to devise a stable international monetary system.

The US Treasury took charge of it, naturally enough. But it neglected its own internal economic policy, partly as a consequence of the Vietnam War, leading to breakdown in 1971-73. In 1969-70, the European Community countries devised a plan for creating a common currency, but it was shelved a few years later. A more realistic attempt was the EMS driven forward by Helmut Schmidt and Valéry Giscard d'Estaing in 1978, intended to liberate Europe from the dollar's dominance.

The independent German Bundesbank succeeded in destroying the EMS's most important elements during negotiations in autumn 1978. As Schmidt wrote in 1990, 'The gentlemen of the Bundesbank are very one-sided in their view of all economic questions. … They are not hostile towards European integration, but they accept it only to the extent that their freedom of manoeuvre is not be limited by European institutions.'

The system degenerated to a fixed rate system after 1987. In 1992-93 it finally collapsed, without much regret, because the plan to create a monetary union, built into the Maastricht treaty, had been launched.

In the mid-1990s, many experienced people, including Erik Hoffmeyer, then governor of the Danish central bank, did not believe that the Germans would abandon the D-Mark, but resistance dwindled after 1997.

In the mid-1990s, many experienced people, including Erik Hoffmeyer, then governor of the Danish central bank, did not believe that the Germans would abandon the D-Mark, but resistance dwindled after 1997.

The euro performed well in the first decade. The euro was accepted by worthies and hucksters alike; it won confidence internationally, and gained ground in international reserves. The financial crisis of 2008 would have hit Europe harder if the euro had not been there.

But in the winter of 2009 something went wrong. The newly-appointed government in Athens revealed that the previous administration had deliberately and dramatically underestimated the budget deficit.

Theo Waigel, the former German finance minister, a key actor in launching the euro in 1999, voiced harsh criticism of the Greeks in spring 2010, terming their action as 'evil'. For him the euro was a means of forcing the German Stabilitätskultur on the other countries.

Like many Germans, Waigel believed 'a common European currency is in the national interest of Germany … because the euro keeps Europe together.' How ironically those words ring now! Politicians and technocrats, bankers and investors: they all failed to understand the forces – elusive, beguiling yet unmanageable – they were unleashing.

And now, whatever it may be, they must pay the price.

In defence of seriousness

Go-for-growth Sapin praises ECB

David Marsh, Co-chairman

Michel Sapin, French finance minister during the Battle of the Franc in 1992-93, is a man who knows all about the rough and tumble of the capital markets. He was at the centre of the French crisis management team that fought off attacks by currency speculators in September 1992, but only with last-minute, grudgingly-purveyed German help. A politically-disastrous devaluation of the French franc or its exit from the exchange rate mechanism, the forerunner of economic and monetary union (EMU), was diverted at the last moment – and France's rocky road to the euro got under way.

Sapin hammers home the message that, if elected, Hollande would restore France's finances more effectively than president Nicolas Sarkozy.

Twenty years later, the euro has grown up to be a disturbed teenager, and Sapin has emerged as a pivotal figure in the campaign for the French presidential election. As adviser to Socialist leader François Hollande, Sapin is likely to become finance minister if Hollande wins the May poll. The French Left has no choice but to project responsibility towards the financial markets – and above all towards France's supreme benchmark, Germany.

Intriguingly, archetypal differences of opinion in France and Germany on how to run economic and monetary policy within a currency union remain visibly on display.

For all these reasons, Sapin, speaking to me at his parliamentary office in Paris in early January, showed caution and conservatism about the implications of the party's campaign programme, since elaborated in a series of surprisingly assured performances by Hollande.

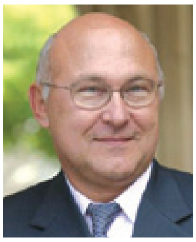
The Socialist candidate has emerged as an early favourite in the opinion polls. Sarkozy suffers from poor personal popularity and a lacklustre economic performance. Yet the Socialists know their lead could soon disappear if the president gets into his stride.

Sapin hammers home the message that, if elected, Hollande would show himself a 'serious' president who would restore France's finances more effectively than president Nicolas Sarkozy, who, he claimed, had frittered away budgetary funds through tax-breaks for the rich that would in future be reversed.

Speaking just before Standard & Poor's downgraded France's credit rating in a well-trailed announcement in January, Sapin puts the move into context. 'I understand the criticism that has been made over the rating agencies. They have made mistakes in the past in rating both private and public sector investment products. But I don't confuse the thermometer with the fever. Even if the thermometer is not working properly, we certainly have fever. I am categorical: the downgrading of France has been caused by the policies of last few years. It is the policies and the results that have been downgraded. I don't wish to see this happen to my country. It could be that this will bring us [the Socialists] some short-term advantages, but the drawbacks are so great over the longer term that I cannot accept that.'

Sapin takes a relatively mild line on mutualising debt though Eurobonds, which Hollande says he backs. 'These could be project bonds for infrastructure investment. The important thing is not the name, but the capability of mobilising international funds through joint borrowing. One example could be project bonds, making investments in areas where we don't at present have the capacity, which produce a real return on investment.'

Asked about Germany's general objection that such bonds would raise German interest rates on borrowing, which have been brought down to new lows by general fears over stability in the rest of the euro area, Sapin counters, 'There not many Germans who believe the present level of German rates is natural. Sometimes they have been too low. The situation is abnormal, because of a flight to quality, into the so-called safe havens. If Germany continues to profit from the fact that interest rates elsewhere are high, that is perverse.'


Michel Sapin

Sapin was eloquent in his defence of the European Central Bank, but made no secret of the Socialists' desire for it to widen its array of monetary policy tools to defeat speculation against hard-pressed euro members. Asked about the ECB taking on wider powers to purchase the bonds of weaker states, he affirms elliptically: 'There is the possibility of the Bank developing its own instruments, not just instruments of fixing interest rates.'

'The ECB does its work very well. I do not criticise it. My profound conviction is that we have been lucky to have had the ECB in the last four years. This is the sole really federal institution in Europe; it has managed the currency and fought disequilibrium during serious crisis. I see absolutely no need to demand anything from it , nor to give it orders . The Bank plays a role of stabilising and supporting the economy and the banking system which is absolutely decisive.'

Commenting on Hollande's promise to 'renegotiate' the new European treaty that is intended to heal EMU's principal defects, Sapin insisted this would be a 'political' rather than a 'technical' renegotiation. 'Budgetary convergence is necessary but not enough... We need measures for growth. Otherwise something is missing. That's why political renegotiation means we have to change some aspects [of the treaty]. What happens afterwards? That depends on the statutes of the treaty and also other issues like the modalities for its adoption.'

Sapin praises Germany's economic success. Like many in France, says the French have to live up to German standards. 'They have completed unification, the economy has recovered, they have improved productivity. In the 1990s, France gained and Germany lost competitiveness. Since then, it has been the other way around. They have recovered their export success. I understand that the Germans are proud of what they have done, and they deserve to be.'

Yet self-interest, he says, should prompt the Germans to do more to promote growth in Europe. 'A county that is so geared to exports cannot prosper if the counties to which they export are in bad health. Most of Germany's surplus comes from Europe.'

Asked about Sarkozy's political flirtation with Gerhard Schröder, the former German chancellor (whom the French leader invited to the Elysée Palace before Christmas for what amounted to a teach-in on German economic policy), Sapin replies, 'For us it is more important to have conversations and common projects with present SPD leaders in Germany. Whatever the respect for such a personality [as Schröder], we have a lot of accord with the present-day Social Democrats.'

This applies, he says, to the need for Eurobonds, which could develop into a common line with the German Social Democrats. Sapin emphasises that such measures have to be based on 'serious' economic principles.

'We have to make efforts for equilibrium. We have to show that we are serious before we reach accords. We have lacked seriousness in the last five years. We must prove that we have the capacity to make a common effort.... Whatever we do to mobilise international savings can be done rather quickly. I am attached not to the word [Eurobond] but to the methods.'

KEY EPISODE IN SEPTEMBER 1992 FOREIGN EXCHANGE UNREST : SAPIN'S ROLE

Why French opposition meant ERM realignment meeting was never held

A key episode in the foreign exchange unrest of September 1992 came after Italy devalued the lira on the weekend of 12/13 September. Germany maintained that it believed, erroneously, based on a meeting in Paris on Saturday 12 September, that Jean-Claude Trichet, director of the French Treasury and chairman of the European Monetary Committee, would convene a full-scale European realignment meeting on Sunday 13 September in Brussels.

This was a principal reason why a larger-scale shake-up on the exchange rate mechanism (ERM) was never considered, which on 16 September heaped pressure on sterling, resulting in the UK leaving the ERM.

The French finance minister at the time was Michel Sapin. In 2007, he explained: 'We [the government] were obsessed by the Maastricht referendum on 20 September. We were convinced that Maastricht was indispensable for the creation of the new Europe. If we created additional tensions on the foreign exchange markets, there would be a greater risk that the referendum would end in a No.'

'At the meeting with the Germans [on 12 September], everyone was ambiguous. We were playing for a calm outcome. We French were certain in our minds that we did not want to have a full meeting of the European Monetary Committee, but we did not express this clearly. The Germans were trying to test whether there was an opportunity for a full EMS realignment, in exchange for a larger cut in German interest rates, but they also did not express themselves clearly.'

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A monthly foray into monetary secrets hidden in archives

Franco-German tension in the air

Secret 1981 Helmut Schmidt proposal to Raymond Barre on cutting Bundesbank interest rates backfires against Paris

Spring 1981 was a fraught time in European monetary relations, foreshadowing the tensions between France and Germany 31 years later during the run-up to the French presidential elections in spring 2012. In April 1981 West German chancellor Helmut Schmidt instigated a complex manoeuvre with French prime minister Raymond Barre to put pressure on the stoutly-independent Bundesbank to cut interest rates. The episode sparked fierce resistance by the German central bank and failed to achieve any German credit easing.

In another foretaste of later Franco-German policy differences, Barre suggested common borrowing by France and Germany on international capital markets. Schmidt turned it down on the grounds that it would raise Germany's interest rate charges. The Bundesbank said it would potentially undermine monetary stability. After the largely unexpected election victory in May 1981 by François Mitterrand, the Socialist candidate, who dispossessed president Valéry Giscard d'Estaing, the suggestion sunk without trace. With the suggestion of common Eurobonds to salvage the euro, the idea resurfaced many years later. Again, so far, it has met a frosty German response.

In 1981, the rising tide of the two year-old policy of tight money inaugurated by US Federal Reserve chairman Paul Volcker spelled trouble for politicians on both sides of the Rhine. Schmidt's one-time protégé Karl Otto Pöhl, Bundesbank president from the beginning of 1980, disappointed his former boss by presiding over a vicious tightening of interest rates in response to an upsurge in inflation potential generated by the stronger dollar. All this put considerable pressure on France ahead of the April-May election. The stabilisation policy of Raymond Barre, the monetary expert and former European Commissioner whom Giscard made French prime minister in 1976, was blown off course by the Bundesbank's tightening.

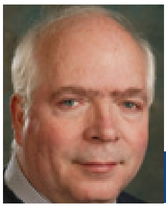
'All European countries are in a bad economic state,' Barre told Schmidt on a visit to Bonn on 2 April. 'An improvement in the economic climate is not in sight.' The French prime minister proposed a joint Franco-German fund using foreign credits that would finance 'economic adjustment to the changed terms of trade', and would also 'improve competitiveness.' But Schmidt spoke out against raising money denominated in the European Currency Unit (ECU), the European Community's composite currency. 'The interest rate on ECU bonds is 3 percentage points higher than on D-Mark bonds,' Schmidt said.

Barre laid out a gloomy view on the economy, saying the trough of the downturn would be reached only in September/October 1981, with recovery from spring 1982 if President Ronald Reagan's economic programme succeeded. 'If interest rates stay high and if the position of the European currencies against the dollar is too strong,' Barre said, 'then Europe would pay a high price – loss of competitiveness.' Directing his criticism closer to home, Barre termed high German interest rates as 'foolish'. If the Bundesbank lowered rates, he said, this would give France welcome manoeuvring room before the election.

Schmidt saw a chance to press the Bundesbank to cut rates. Such attempts to influence the central bank were not permitted by the Bundesbank Law. However if the recommendation came from a foreign leader, perhaps it might work? So Schmidt asked Barre whether (in the words of the official German government account) he would 'formulate his views about the interest rate policy of the Bundesbank in a letter addressed to him.' Barre said he was 'ready to do this.'

The French prime minister was quick off the mark. The next day, 3 April, Barre's letter to Schmidt arrived in the Bonn Chancellery, saying, 'It would be very advantageous if interest rates could be reduced to a more moderate level. This would promote an economic recovery in Germany and, as a result, in other countries.' Schmidt sent the letter immediately to Pöhl in Frankfurt, where it was discussed by the Bundesbank directorate before Pöhl and his deputy Helmut Schlesinger wrote back to Schmidt a precisely-argued missive on 15 April rejecting any question of lower rates. Pöhl did not know that Schmidt, not Barre, had suggested the letter. But at the Bundesbank council meeting on 23 April, Pöhl surmised (correctly), 'I cannot believe that he [Barre] would have written the letter had he not assumed that the chancellor would approve it.'

Any question of a pre-election Bundesbank rate cut to aid Giscard and Barre was taboo. In the second round of the election on 10 May, Mitterrand swept to power propounding a set of stimulatory economic policies that stood in sharp contrast to German orthodoxy. At the next Bundesbank council meeting on 21 May, Pöhl told his colleagues that the French might have to devalue the franc. 'France creates a considerable problem for us.' Plaintively he asked his colleagues: 'How long will the French carry on with this policy? What do they really want?' Thiry years later, if Francois Hollande wins on 6 May 2012, it is likely that central bankers in Germany will be asking the same questions.



Transparency raises new questions

Fed watchers now have more to watch

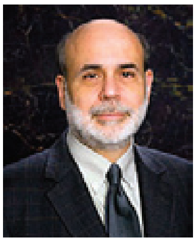
Darrell Delamaide, Board of Contributing Editors

There's some speculation that President Barack Obama's decision to defy Congress by making a few key recess appointments even when the Senate claimed to be technically in session will now delay the Federal Reserve nominations announced in December.

Elizabeth Duke

The paired nominations of two candidates, **Jeremy Stein** and **Jay Powell**, with Democratic and Republican affiliations respectively, was thought to be a way of getting through the obstacle of a Republican filibuster on appointments. But the appointment in January of Richard Cordray to head the controversial Consumer Financial Protection Bureau has raised hackles in the Senate and it remains to be seen whether Republicans will retaliate by blocking all appointments. The president's call for the Senate to reform its rules and guarantee an 'up-and-down' vote on all nominations within 90 days is not likely to get much of a hearing in this environment.

One of the board terms, that of **Elizabeth Duke (voter)**, expired at the end of January, but she said she would continue to serve on the board, as the law allows, until a successor is appointed. At his press conference at the end of the month, Fed chairman **Ben Bernanke (voter)** refused to be drawn into any discussion of politics. When asked about the vow of some candidates for the Republican presidential nomination to ask for Bernanke's resignation, the chairman had a ready answer. 'I'm not going to get involved in political rhetoric,' he said. 'I have a job to do.'



Ben Bernanke

Fed watching on steroids

The Fed's new policy on transparency will hardly put Fed watchers out of business – it just gives them more to watch. While Chairman Bernanke's pledge that the monetary policy panel would keep rates at virtually zero through the end of 2014 – 18 months longer than the previous pledge of mid-2013 – seems clear enough, some of the other information released raises new questions.

For instance, Fed projections on unemployment show an expected decline in the jobless rate only to a range of 6.7-7.6% by the end of 2014, well above the targeted unemployment rate of 6%. And yet, the already famous dot graph of FOMC member projections on interest rate policy shows a majority ready to raise rates by the end of 2014. So the question is how can the Fed contemplate raising interest rates when it is still so far from fulfilling the second half of its dual mandate.

The disparity prompted some Fed watchers to conclude quickly that the FOMC is ready to launch another round of asset purchases (QE3) to further buoy the economy and move the needle on those unemployment projections. Bernanke stoked those suspicions at his 25 January press conference. 'We need to adopt policies that will both achieve our inflation objectives and help the economy recover as quickly as is feasible,' he said. 'We need to be thinking about ways to provide more stimulus if we don't get some improvement [in the economy].' Formalising the inflation target at 2% and demonstrating that it is running well below that rate are further indications that the Fed is ready to act again. Some Fed watchers expect QE3 to be announced at the next FOMC meeting, in March, or at the April meeting.

William Dudley

Dudley calls unemployment 'unacceptably high'

New York Fed president **William Dudley (voter)** provided further confirmation in a speech and remarks to reporters two days after the FOMC meeting. Unemployment, Dudley said in New York, is likely to remain 'unacceptably high' while inflation will remain below 2% and is likelier to decline than accelerate.

'Clearly, much work remains to achieve the Fed's dual mandate of maximum sustainable employment in the context of price stability,' Dudley said, according to press reports. The release that day of fourth quarter GDP figures showing an annual growth rate of 2.8%, up from 1.8% in the third quarter, belied some of the Fed's pessimism, however.

Some economists see the US recovery gaining strength this year, in spite of recessionary trends in Europe. US banks, which are relatively healthier than those in Europe, could resume more aggressive lending and put pressure on the Fed to tighten monetary policy sooner than unemployment figures might warrant, this line of reasoning goes.

A few FOMC members evidently share this belief. Three of the dots are looking for higher interest rates in 2012, and three more in 2013.

Presumably, these dots represent some of the regional Fed chiefs, because if they were voting governors, there would be a majority for interest rate hikes in 2013 and Bernanke would not have forecast unchanged rates through 2014.

'Monetary policy is given credit for entirely too much influence on real economic activity,' Lacker said.

Jeffery Lacker

Lacker is back

Richmond Fed chief **Jeffrey Lacker (voter)** wasted no time exercising his vote on the Federal Open Market Committee after a two-year hiatus. In the first meeting of the new year last month, Lacker was the sole dissenter among the 10 voting members.

The 25 January FOMC statement, which said members see low rates being maintained through 2014, noted that Lacker voted against the statement because he 'preferred to omit the description of the time period over which economic conditions are likely to warrant exceptionally low levels of the federal funds rate.'

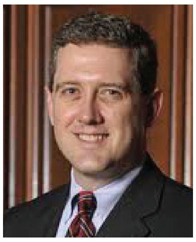
In other remarks, Lacker has made it clear that he has a fundamentally different view about the role of monetary policy. 'Monetary policy is given credit for entirely too much influence on real economic activity,' he said in a speech in Richmond earlier in the month.

Specifically, he told reporters on that occasion, the Fed has no business trying to stimulate the housing market. 'If we do that we are just withdrawing credit from some other market and we are not the ones to decide that,' he said.

Dennis Lockhart

The Fed took the unusual step at the beginning of January of sending a 26-page white paper to lawmakers about how the housing market remains a major impediment to economic recovery. The paper urges policy-makers to consider ways of unblocking finance for housing purchases, particularly through loan modifications.

The other regional chiefs who rotated into voting positions on the FOMC this year – **Sandra Pianalto** of Cleveland, **John Williams** of San Francisco, and **Dennis Lockhart** of Atlanta – all voted in favour of the consensus statement.



James Bullard

Bullard believes in monetary impact

While Lacker worries that the impact of monetary policy is overrated, St. Louis Fed chief **James Bullard (non-voter)** feels that monetary stimulus has proven so effective at stabilising the economy, even with interest rates near zero, that policy makers can abandon their flirtation with fiscal policy as a short-term stimulus.

The consensus prior to 2007 was that fiscal policy was ill-suited to short-term stabilisation, in part because of the politics involved, and should rather set the framework for medium and long-term planning.

With the onset of the financial crisis, however, some questioned whether monetary policy could be effective when interest rates could be lowered no further than zero.

The experience of the past few years has demonstrated that it can, Bullard said in a presentation in St. Louis. 'When monetary stabilisation policy is effective, it is not necessary or desirable to turn to fiscal stabilisation policy,' he said.

Bullard's conclusion: 'The turn toward fiscal approaches to stabilisation policy has run its course, and that the conventional wisdom that existed in the decades prior to 2007 is being re-established in the U.S.'

Italy and Spain making progress

Concerns slacken over problem countries

DZ Bank Economic Forecast Table

GDP growth	2011	2012	2013
US	1.7	2.0	2.0
Japan	-0.7	1.8	1.3
China	9.2	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	-0.8	0.0
UK	0.9	0.8	0.5
Addendum			
Asia excl. Japan	7.4	6.6	7.7
World	3.6	3.3	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	2.3	2.1	2.2
Italy	2.9	2.2	2.3
Spain	3.1	1.5	2.1
UK	4.5	2.5	2.3
Current account balance (% of GDP)			
US	-3.1	-3.2	-3.1
Japan	2.1	2.5	2.8
China	3.6	2.9	3.1
Euro area	-0.6	-0.7	-0.6
Germany	5.1	4.7	4.3
France	-2.2	-2.3	-2.0
Italy	-3.6	-3.3	-3.2
Spain	-4.5	-4.3	-4.3
UK	-2.5	-3.0	-2.0

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

Concern over the euro area sovereign debt crisis has lost some of its intensity in recent weeks. This has been demonstrated by lower spreads on Spanish and Italian government bonds and the general rally in stock market prices. Several highly indebted countries are now getting economic policy reforms under way. At the level of the European Union as a whole, progress is under way towards a new fiscal pact as the key to ensuring Europe's future commitment to a sustainable consolidation policy.

It is still too early to sound the all-clear, however. The interim government in Greece is still wrestling with powerful factional interests and fractious parliamentary groupings over necessary structural reforms and economies. Success is far from certain. Should the visiting troika deliver a negative verdict, Greece would be in touching distance of bankruptcy.

The resulting nervousness is rippling out to Portugal, underlined by the sharp widening of sovereign spreads on Lisbon's bonds, in contrast to the narrowing of the interest rate gap for Italy and Spain. Although the Portuguese government is now showing much greater resolve with regard to budget consolidation and cooperation with the European Union and International Monetary Fund, confidence in its ability to sustain the reform drive remains weak. There is still substantial risk of setbacks. With this proviso, however, we now rate the odds on our base scenario (a gradual amelioration of the crisis over the coming months) as slightly improved compared with a month ago.

Turning to the German corporate sector, companies are now again viewing the outlook for the economy with increasing confidence. This is the clear message from the latest surveys. The January Ifo business climate index showed its third successive monthly improvement, suggesting a trend turnaround from the falls recorded over the course of 2011. The swing in sentiment is especially marked in the manufacturing sector where greater confidence is now becoming general, not least with regard to export opportunities. We see this as confirming our expectation of an improving economy during 2012. After the dip in output during the closing quarter of 2011, we now expect the economy to return to growth as early as the current quarter. A German recession is improbable in our view.

The latest GDP data from the US and China were more or less in line with expectations. The US economy ended last year on a decidedly upbeat note with output expanding by 2.8% on a quarterly annualised basis. This leaves the full year 2011 GDP growth rate at 1.7%. The Chinese economy is still easing back – shown by growth slowing slightly to 8.9% in the final quarter of 2011. This is the lowest growth rate in more than two years. Yet, compared with the significantly reduced expectations that stemmed mainly from the relatively weak trend of the purchasing manager indices, this outcome is still a positive surprise, resulting in full year 2011 GDP growth of 9.2%, a little above our latest forecast.

Heading for Bernanke bubble

Third phase of expansive monetary policy

Stefan Bielmeier, Advisory Board

Ben Bernanke, chairman of the US Federal Reserve, has upped the ante. Not only did he raise the prospect at the last Federal Open Market Committee meeting on 25 January that the current low interest rate environment will remain in place. He also suggested that the duration of the 'low interest rate guarantee' could be extended further. Monetary policy is now expected to provide significant support well into 2014, compared with the previous position that rates would remain on hold until at least mid-2013. This means overall long-term yields should remain low for a relatively long period, especially since Bernanke did not rule out more quantitative easing if deemed necessary.

The objective of supporting the US economy and helping generate stronger growth is both appropriate to the current situation and in line with the central bank's mandate. However, the process set out by Bernanke is not without risks.

Twice in the last 15 years, the Fed's expansive monetary policy and explicit aim of supporting the economy have significantly contributed towards capital misallocation and bubble creation. In the late 1990s, the Fed kept interest rates low, thus indirectly supporting the creation of the dotcom bubble that ultimately burst. The subsequent next very long phase of low interest rates prevented imbalances within the economy from being corrected and created the basis for the housing market boom, the collapse of which almost lost us the global financial system.

Twice in the last 15 years, the Fed's expansive monetary policy and explicit aim of supporting the economy have significantly contributed towards capital misallocation and bubble creation.

The third phase of expansive policy could create a new bubble, perhaps with even more drastic implications. The current round started in 2009 with US quantitative easing. The equity market (S&P500) has climbed by 100% and commodities by 70% since then, and 10-year Treasury bonds are at an all-time high. The rise in asset prices doubtless helped prevent an even greater decline in the US economy, triggered by a (necessary) correction of imbalances.

Households have played their part in stabilising the economy and continued to consume on a relatively solid basis. The rise in asset prices drove up wealth despite the high level of debt, and some of the (book) profits have been translated into consumption. In the last few months the US economy has stabilised, industrial production has shown some encouraging signs and the housing market has bottomed out.

Against this background, the threat posed by the Fed's plan for a long phase of expansive monetary policy seems still more pronounced. The risk is that not only savings but also a substantial amount of borrowed capital, which is in turn secured by over-valued assets, is invested in such assets (as it was for example, in Japan in the 1980s or in the US at the height of the property bubble). Eventually, as past events have taught us, this would lead to a bursting of the bubble and a downward spiral.

The environment is becoming more conductive to such a development. US Treasury bond yields are below the inflation rate across almost the entire maturity range. Savings cannot effectively be invested to maintain purchasing power. So there is a massive incentive to invest this capital in tangible assets.

Low interest rates quickly lead to high leverage and to investment in projects that would not be profitable in a 'normal' interest rate environment. The intriguing question is whether the Fed will succeed in mastering the balancing act of, first, providing the economy with necessary support and then withdrawing liquidity in good time. Clearly, the greatest risks are present on the bond market. So there is a strong case for selective investments in the equity market in the years ahead, provided caution is exercised once indicators such as the price/book value ratio imply overvaluation.

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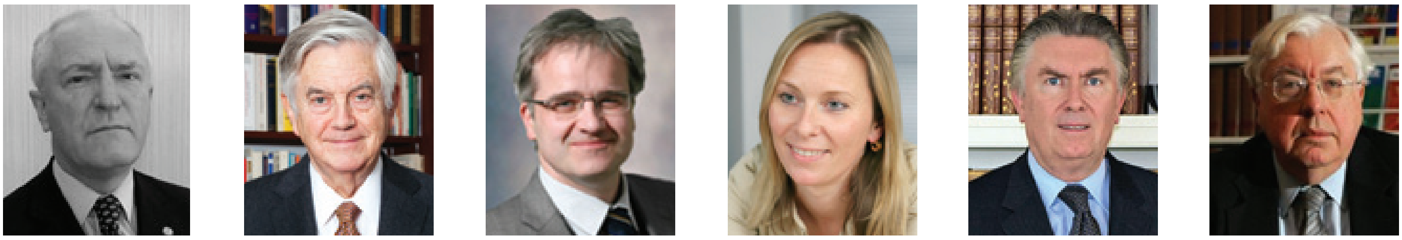

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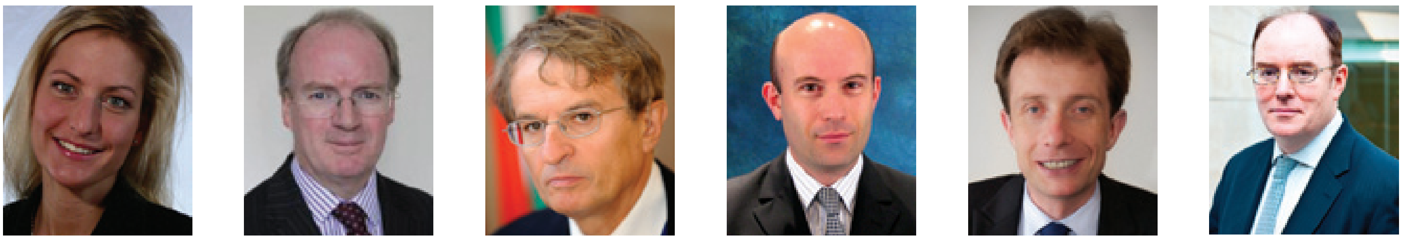

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Vickers comes to Europe

Guidelines not rules likely from Liikanen commission

Michael Lafferty, Co-chairman

The UK concept of ring-fencing retail banking activities within a universal banking group – or even going further to separate totally investment banking from commercial banking – is beginning to attract attention in continental Europe. Universal banking enthusiasts in Paris are already describing this is an Anglo-Saxon plot.

First, in early January came news that 'separation', as it is called, is to be considered by a high-level EU study group chaired by the Finnish central bank governor, Erkki Liikanen. His commission is expected to report in the summer. This follows in the footsteps of last year's findings on UK banking conditions under Sir John Vickers that recommended ring-fencing banking activities. French presidential challenger François Hollande announced in January that, if elected, he would introduce a law obliging French banks to separate credit activities from 'speculative' investment banking.

This is in the context of a somewhat theatrical war against the 'world of finance' that plays well to the large body of opinion across Europe, and especially in France, that believes financial institutions are at the root of the financial crisis. As Hollande put it, 'If finance is our enemy, then we must confront it with our own means, first of all on our own territory, tempered neither by weakness nor by lack of realism, believing it will be a long battle and a hard test, but one where we will demonstrate that we, too, are armed for the struggle.'

While EU Financial Services Commissioner Michel Barnier is said to be a supporter of universal banking, the decision to set up the expert study group under Liikanen follows pressure from the European parliament and some members of Barnier's own staff who were concerned that Europe is falling behind the UK in bank reform.

The expert group will take an open-minded approach to the process and will carry out a thorough review of all regulations and legislation in this field, including in particular the Volcker rule established in the US for separating banks' proprietary trading activities from their commercial banking, as well as the Vickers commission in the UK.

Given Europe's patchwork different history, structures and customs applied to investment and retail banking, it is highly unlikely that the Liikanen commission will result in a 'one size fits all' framework for separating banks' activities. It is more likely to come up with precepts and guidelines than with a hard-and-fast rulebook.

Governor Liikanen is one of the longest-serving members of the European Central Bank governing council following a spate of retirements and other departures over the past 12 months. Last year he was appointed to a second seven year term at the head of the Bank of Finland.

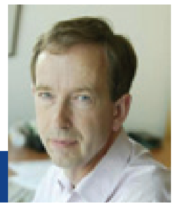
A social democratic politician, a former Finnish finance minister and a former eurocrat, Liikanen seems to have been chosen since he is as a safe pair of hands. However, critics in Finland point out that Liikanen was Finland's finance minister from 1987 to 1990 – the time that Finland's housing crisis started that later triggered the need for large-scale Finnish banking rescues.

It is too early to say whether the tide of history is turning against universal banking in mainland Europe. But a serious UK-style debate could be in the offing – particularly if taxpayers in countries such as France, Germany, Italy and Spain are forced to bail out major national banks. If technocrats and politicians alike realise what is at stake with unfettered universal banking, they may become advocates of full separation of the 1930s Glass-Stegall variety, or ring-fencing of retail banking within the broader universal banking group as is now UK government policy. The eagerly awaited Liikanen report will be a milestone along the way.

Hollande's campaign is in the context of a somewhat theatrical war against the 'world of finance' that plays well to the large body of opinion that believes financial institutions are at the root of the financial crisis.

Looking at separation

Splitting banks is not the answer



Dirk Schoenmaker and Casper de Vries

Many western governments, including the Dutch, spent a large amount of public money rescuing the banks during the financial crisis. In response, a policy debate on the appropriate structure of the banking system has emerged. The twin objectives of banking reform are to establish a safe and stable banking system serving the needs of customers (retail consumers and corporates) and minimising use of public money in financial crises.

Following the recommendations of the Vickers Committee, the UK is preparing legislation to split banks into safe retail banks (with public insurance) and investment banks (without public insurance). The issue has take on international dimensions. Will splitting retail and investment banking be the answer? We argue not. An overall split would harm the financing of retail consumers and corporates by increasing the cost of banking without solving the problem. The so-called 'safe' retail banks may in practice be less safe, as their business would be restricted to retail consumers and possibly small and medium-sized enterprises (SME). Both housing loans (the main component of consumer finance) and SME loans are risky. Housing price bubbles are at the root of most financial crises.

We argue that there is a case for ring-fencing proprietary trading with higher capital requirements for banks with public insurance. Moreover, we propose five additional measures to restrain risk in banking:

- More equity capital in banks reducing the incentive to take excessive risks
- Macro-prudential supervision to prevent/mitigate loose credit conditions fuelling asset price bubbles and undue reliance on wholesale funding
- Prompt corrective action by supervisors, when problems emerge at banks
- Plans that allow supervisors to resolve systemically important banks at low cost
- Improving governance to foster a sound risk management culture

With regard to the 'headline' issue of splitting banks, the main argument is that only the retail part is crucial for the economy and relatively safe, while the investment part may give rise to undue risky transactions for profit. However this argument is only partly correct. Investment banking is also needed for the basic financing needs of corporates, which plainly need to manage their financial risks regarding funding and foreign trade.

Importantly, retail banking is not necessarily safe. Retail banks take deposits from, and provide loans to, households and corporates. So they avoid the risk of trading and derivatives. But these banks are more exposed to housing and SMEs. Examples of housing price bubbles causing crises were seen with the Savings and Loans in the US in the 1980s and the Cajas in Spain currently. The previous time before the present financial crisis when several banks failed simultaneously in the Netherlands was in the 1980s, when several mortgage banks failed because of their undiversified exposure to housing.

Even if we wanted to split the banks, can it be done? It is very difficult to have a clean separation. In the UK, the proposed border between retail and investment banks is flexible Some financial transactions (such as trade finance and project finance) could be placed either in the retail part or investment part. Finally,would the split be effective? There is an economic drive to exploit group synergies by doing inter-company transactions. A related issue is reputation risk. Simplification of corporate structures would help supervisors get a better overview of large banking groups. However, markets tend to regard the strength of a banking group as a whole, ignoring the legal structure. As witnessed in the case of Lehman Brothers in 2008 and earlier of Drexel Burnham Lambert in 1990, solvent subsidiaries (separated legal entities) of a banking group can hardly survive when the parent company or a major subsidiary is in serious trouble.

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This article is based on Duisenberg School of Finance Policy Brief, No. 12, Towards a Safer Banking System: Is Splitting Retail and Investment Banking the Answer?, by Dirk Schoenmaker and Casper de Vries

An occasional look at the great characters of world finance

An encounter at Annabel's

Some home truths on what's changed in banking

Frederick Hopson, Advisory Board

My dear old friend Bertram the banker had been out of touch for a while. I had not really been able to talk with him since our lunch at Harry's Bar in December 2010 when he correctly predicted that bankers were still in charge and the show would go on regardless. My feeling was he might be lying low. So I was somewhat surprised when he called me and invited me to Annabel's, sister establishment to Harry's.

I had thought that the current state of the financial world might have resulted in slightly less conspicuous consumption and perhaps even a touch of humility on his part. But one tends to underestimate the sheer brass of our moneyed brethren. It was about 8.30 and the club was still quite quiet. Just a few very tall blonde and leggy ladies grouped around the entrance bar and a couple of dark suited males seated in the private alcove.

Bertram smiled at them in his lascivious way and led me to a secluded table.

I was a little surprised to see that Bertram wasn't wearing a tie with his hand-made Hermes suit. I had thought that was de rigueur in this illustrious venue. But he explained that, in the new boom, the rules had been relaxed. Some of the younger generation who had made their hundreds of millions preferred a more casual atmosphere. As he ordered a bottle of Krug, my first astonished exclamation was: 'What boom? Taxes are increasing, half of Europe is bankrupt, banks no longer lend to anybody, not even each other and the public is up in arms about bank bonuses and austerity measures!'

'My dear Rod, you really don't get it, do you? If 50m people pay £1000 more tax that's £50bn. Much more sensible to go after the man on the street than to tax rich individuals. Taxing a millionaire at more than 50% just drives the wealthy elsewhere. The Greeks understand. That's why they all come to London especially as they can get non-domiciled status.'

'Also it may be true,' Bertram droned on, 'that many European countries can't repay their debts. History is full of sovereign defaults. The world has survived them all, with some minor blips and a few sticky problems like the Second World War of course. Hence the absolute necessity to avoid any type of Weimar situation in the bigger states.' Bertram smiled his ironic smile. 'Smaller ones can be written off quite quickly especially if the ECB keeps lending to the banks at close to zero per cent.'

'Hang on a second, Bertram,' I interjected. 'Banks have lower share prices than 12 years ago, yet they pay themselves 10 to 20 times more than then. And how do you square the huge bonuses they're still paying themselves? We've lost all sense of proportion!'

Bertram slowly sipped his glass of champagne, and gazed lazily over to a couple of Russian beauties. 'Look, capitalism is dead anyway in the traditional sense. We have managers who now dictate the rules of the game, Karl Marx already saw that coming. Executives have successfully extracted shareholder value, admittedly from the shareholders to themselves. Forget about the bonuses. Banks have long since doubled base salaries. If you've read "The Big Short" you are probably aware that most banks didn't understand exactly what they were doing during the mortgage crisis anyway, a bit like the CEOs in the dotcom boom, the only difference was a few of them went to jail, the world is more forgiving today!'

I interjected: 'The bankers have successfully lobbied in their respective countries even appointing failed bankers to advisory positions for very high salaries. What is the world coming to? Is there no financial integrity?'

'Rod, try and follow my thought processes. With the banks it's different, the governments have been involved from the start and money is a very sensitive business. So nobody can allow the banks to go under, think of all those depositors and pension funds. That's not the way to get re-elected. Can you expect the bankers to have integrity when dealing with politicians every day? '

We were ushered to our table and a magnum of Beychevelle arrived. 'Are we supposed to drink that alone,' I asked?. 'No of course not, I've invited a couple of friends,' He winked to the blonde girls who had been waiting. Beaming, a very well-known MP started towards us. Somehow, I knew I'd see his face again.

Pearls of wisdom on euro road

What leaders said about single currency adventure

The EMU adventure has given rise to a large variety of judgments over the last two decades. Here is a selection.

'It is dangerous that the Central Bank, in the absence of a political authority, should have sovereign power. The [European] Monetary System is already a German zone. But Germany does not have authority over our economies. With the [European] Central Bank it would have it.' *François Mitterrand, French president, March 1989.*

'If we have a single currency and the Germans are unified, that will be insufferable.' *Margaret Thatcher, British prime minister, September 1989.*

'The [British] Government always does what the City wants … The City will ensure that Britain joins monetary union.' *Helmut Kohl, German chancellor, December 1991.*

'Of course the Germans resist this [monetary union]. The D- Mark is the manifestation of German power. This is a very deep issue that transcends the reflexes of bankers, and goes even beyond politics.' *François Mitterrand, French president, August 1997.*

'The euro will be a premature sickly child.' *Gerhard Schröder, Social Democratic Party chancellor candidate, March 1998.*

'Now that Germany has gone through a difficult time, lowered its costs and has recovered competitiveness, the other countries have to do the same. There is no way that Germany is going to produce significantly more inflation to help out the others.' *Gerhard Schröder, former German chancellor, April 2007.*

'The overall political situation in Europe made monetary union both necessary and desirable. If the political will was there, it would have been wrong – and impossible – for the Bundesbank to oppose it.' *Helmut Schlesinger, former Bundesbank president, July 2007.*

'European leaders have created a psychology of looming collapse which could be self-fulfilling. Greece has become a laboratory animal in the battle between Europe and the markets.' *George Papandreou, Greek prime minister, February 2010.*

'It would be a disgrace if it turned out to be true that banks that had already pushed us to the edge of the abyss were also party to falsifying Greek statistics.' *Angela Merkel, German chancellor, February 2010.*

'Those who argued there can be no monetary union without political union are precisely those who should welcome political union now that it finally knocks at the door claiming its rights.' *Tommaso Padoa-Schioppa, former Italian finance minister, February 2010.*

'ECB bond purchases are a threat to stability.' *Axel Weber, Bundesbank president, May 2010.*

'The worst is over.' *Jürgen Stark, ECB board member, July 2010.*

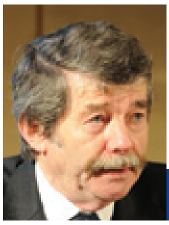
'The EU made great mistakes by deciding to start EMU with a wider group of countries.' *Helmut Schmidt, former German chancellor, November 2010.*

'A Greek default would cause the breakdown of the financial system as we know it.' *George Soros, international financier, October 2011.*

'The Greeks think that, whatever they do, they will get the money.' *Jürgen Stark, ECB board member, October 2011.*

'Now that Germany has gone through a difficult time, lowered its costs and has recovered competitiveness, the other countries have to do the same. There is no way that Germany is going to produce significantly more inflation to help out the others.' Gerhard Schröder, former German chancellor, April 2007.

A regular round-up on international monetary affairs



Cameron's invented 'veto' victory

Playing to the back benches on Europe

William Keegan, Chairman, Board of Contributing Editors

When David Cameron made a great show of exercising what looked to the initiated to be a non-veto of euro leaders' plans in mid-December, he was apparently asked by a eurocrat: 'Why are you doing this?' To which I am told he replied: 'You don't understand. My job is at stake.'

Yes, Cameron felt himself to be under such pressure from his eurosceptic backbenchers in Parliament that he had to invent an issue and declare victory – a victory which was duly hailed by the tabloid press.

Europe haunts Conservative leaders. Churchill himself was in favour of a united Europe, provided Britain went its own separate way.

We were slow to apply to join what was then known as the Common Market, humiliatingly rejected by our wartime guest General de Gaulle when we finally applied, and admitted in the end largely because of the bond between Edward Heath, most pro-European of our prime ministers, and de Gaulle's successor Georges Pompidou.

Thatcher fought ferociously for Britain's budget rebate – but, as Lord Gilmour recorded in his memoirs, appeared to be more interested in the fight, to please Conservative backbenchers and a largely Conservative press, than in the settlement. She was against joining the exchange rate mechanism (ERM), but worn down by Cabinet colleagues who in those days were mostly pro-European. One of the most persuasive, John Major, presided two years later over the collapse on Black Wednesday of the policy he had advocated and she had (initially at least) rejected.

David Cameron was an aide to Chancellor Norman Lamont at the time of Britain's forced withdrawal from the ERM. Cameron's father, chairman of Whites, one of the most Establishment of English men's clubs that you could imagine, was notoriously eurosceptic. His son is more pragmatic, and, despite describing himself as a eurosceptic, managed in the closing days of January to soften his stance on the euro fiscal treaty, a move that was bound to incur the displeasure of his backbenchers.

Cameron, like Gordon Brown before him, has taken to lecturing the euro area in general and the Germans in particular on how to run their economic affairs. This goes down well with the backbenchers from whom he continually fears a revolt over Europe.

The British prime minister has adopted an increasingly populist tone – not unlike that of his predecessor many decades ago, Harold Macmillan, also an old Etonian. Indeed, the satirical magazine Private Eye recently produced a brilliant cover to mark its 60th birthday, with pictures of Macmillan and Cameron, and a caption suggesting that little had changed in the way Britain was run.

Now, I referred recently in this column to the outbreak of verbal protectionism in Europe, with British and French Ministers arguing about their countries' respective credit rating. Hostilities have continued with President Sarkozy's rather wild jibe that 'The UK has no industry any more'.

But there was a serious point behind Sarkozy's remark. Despite congratulating itself for being outside the euro, the UK is hardly in a strong position to boast about recent economic achievements. And there is a sense in which, to borrow one of Cameron's slogans about the UK, we Europeans, when it comes to the crisis are 'all in this together'.

David Marsh in his book 'The Euro' vividly explained the political motivation behind the birth of the euro.

Memories of the Second World War and the inter-war years figured prominently in the minds of Chancellor Kohl and President Mitterrand. Even for sceptical Britons, the European Union was itself a magnificent achievement, which had brought previously warring nations together.

Yet for many the euro, in the way it was formed, was a step too far. It would be a tragedy if the evolving economic policy regime were to result in the kind of social dislocation and rise of nationalism that the euro's architects wanted to avoid.

Looking ahead – 2012 diary dates

Lecture with Klaas Knot
President, De Nederlandsche Bank
17 February 2012, London

Lecture with Ewald Nowotny
President, Austrian National Bank
28 February Lecture, London

Lecture with Patrick Honohan
Governor, Central Bank of Ireland
8 May 2012, London

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

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

Word Banking & Finance Summit
Managing Economic Transformation
26-27 June 2012, London