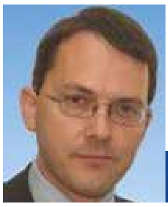
OMFIF BULLETIN

Global Insight on Official Monetary and Financial Institutions

2013 YEAR OF THE LUSO-ECONOMY

February 2013



Bullishness and brinkmanship

Growth pick-up without monetary tightening

Trevor Greetham, Advisory Board

With growth picking up and inflation muted, the world's leading central banks have confirmed that there will be no abrupt monetary tightening in coming months.

Potential tensions in economic and monetary union (EMU) have not disappeared and this is one reason why Mario Draghi, the European Central Bank president, repeatedly highlighted the bank's 'accommodative' monetary policy in his monthly press conference on 7 February.

Higher growth with monetary policy remaining loose represents a bullish combination for equities, so global stock markets should again do well in 2013 after a 17% rise during 2012 (compared with government bond returns of just 1%).

Commodity prices will rise as a synchronised recovery takes hold. This has the potential to last for much of 2013. On the downside, financial market sentiment appears excessively bullish and political brinksmanship over US fiscal tightening, as well as possible hiccups in EMU depending on the outcome of this month's elections in Italy and Cyprus, could still create volatility over the next few months.

The EU's decision on 8 February to peg the European budget at 1% of GDP signals an important alignment between the UK and Germany. David Cameron, the British prime minister, could gain more support in his campaign to generate a more efficient, competitive, open and accountable EU.

In the long run the European budget is likely to grow as a share of GDP if it is to act as a mechanism for legitimate fiscal transfers between euro area countries, but that would require significantly more political oversight than we see at present.

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Japan closer to appointing 'deflation hawk' Iwata as next governor

Shumpei Takemori, Advisory Board

The Japanese government has almost certainly decided the future Bank of Japan governor, likely to be 'deflation hawk' Kazumasa Iwata, a former BoJ deputy governor. Shinzo Abe, the Japanese prime minister who has controversially affirmed the BoJ's central role in a new 'go-for-growth' strategy, appears to have made up his mind. (*continued on page 10…*)

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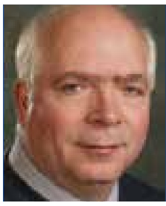


Soft landing

Bernanke for Princeton

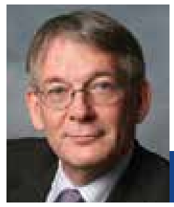
Darrell Delamaide, Advisory Board

Federal Reserve Chairman Ben Bernanke has reportedly told friends he will step down when his term ends next January. Most Fed watchers think this means he would not accept a third term even if President Barack Obama were to offer it.

In a convenient juxtaposition, Shirley Tilghman, president of Princeton University, has announced she will step down at the end of the academic year. There are people inside and outside the prestigious private university, where Bernanke was a tenured professor, who think he may be in line to be her successor.

A high-level university post would be a soft landing for a former Fed chairman. The soft-spoken and consensus-building Bernanke would doubtless fare better than former Treasury Secretary Larry Summers, who became president of Harvard University when he left the Clinton administration.

(continued on page 10 ...)



Array of tasks

Positive start, sombre undertones

David Marsh, Chairman

OMFIF has opened 2013, the Year of the Luso-Economy and Renminbi Focus, in some style. A landmark symposium in Beijing in mid-January with Chinese financial think-tank CF40 produced new insights into cooperation and competition between China and Europe. Ideas and initiatives linking the Portuguese-speaking countries in Europe, Asia and Africa will be a feature of the year ahead.

This wide-ranging February 2013 issue takes a searching look at the issues behind relative sanguinity on financial markets. They have opened the year on a positive note, but it's impossible to overlook a sombre undertone. Trevor Greetham draws comfort from central banks' unwillingness to slam on the monetary brakes. In an excellent survey of historical patterns, Gabriel Stein sees interest rates rising, eventually, by 2 to 3 percentage points. Stefan Bielmeier comments dourly that financial markets are living in a make-believe word – but leaves open the timing of when they may wake up.

Shumpei Takemori surveys the signals indicating that Kazumasa Iwata will be the Bank of Japan's next governor, part of the go-for-growth strategy of new prime minister Shinzo Abe. William Keegan delivers his latest round-up of changes at the Bank of England under the shifting eye of UK chancellor of the exchequer George Osborne.

Meanwhile, Ben Bernanke is contemplating his exit. Darrell Delamaide reports that a convenient berth may be Princeton University. In his monthly round-up of Fed activity, Delamaide demonstrates how the US central bank is growing increasingly comfortable with its policy of asset purchases.

Taline Koranchelian and Alison Stuart from the International Monetary Fund describe the Fund's efforts to reinforce and internationalise its surveillance activities, where previous shortcomings were painfully laid bare by the financial crisis.

Two senior Chinese financial specialists, Jin Zhongxia, Head of the Research Institute at the People's Bank of China, and Miao Jianmin, Chief Executive of China Life Asset Management, provide startlingly realistic views on the international monetary system. Jin's affirmation of the long-term resilience of the dollar contrasts with China's previous support for a new international currency. One reason cited by Jin for the dollar's underlying strength lies in energy developments, expertly surveyed (in the case of Shell's espousal of shale gas in Ukraine) by Nick Butler.

Miao says the euro bloc needs to go further to shore up its structures. Governor Carlos da Silva Costa of the Bank of Portugal admits that the euro's architecture was 'flawed from the start' but recounts the considerable progress made towards improvement.

Moorad Choudhry assesses the consequences for banks' business models of changes in the bank funding environment. We summarise the views of the Alley & Overy Global Law Intelligence Unit of the controversial New York court ruling on Argentine sovereign debt. Martin Raven says Brazil provides much to admire as well as to denigrate.

Britain's call for negotiations on a more competitive and open European Union, with the result to be put to an 'in-or-out' referendum, has stirred conflicting passions. We provide three divergent reactions, from Laurens Jan Brinkhorst, John Kornblum and Thomas Kielinger. This month's postscript is by Roel Janssen who sums up the tough array of tasks facing Jeroen Dijsselbloem, the Dutch finance minister and Eurogroup chief.

David Marsh

Brazil's potential for growth

Infrastructure plans attract foreign investors

Martin Raven, Advisory Board

Brazil has undoubted problems. But its future contribution to the world economy is secure, and can be summed up in three words: land, food, and people. Brazil has an investment grade rating from the main agencies, is a net donor to the International Monetary Fund and survived the transatlantic financial crisis relatively unscathed.

Brazil's abundant natural resources make it relatively resilient to global vicissitudes. The country has over 22% of the world's land available for agriculture.

Growth declined to around 1% in 2012, and inflation is on the rise, but the country is still, on the IMF's dollar-based figures for 2012, the world's seventh-largest economy, marginally behind the UK. (Both weigh in at $2.4tn.) Brazil's double-digit growth took place between the 1960s and the 1980s. Although close to a 4% rise is expected in 2013, the economy is just too large to repeat previous heady expansion.

Brazil is coming under the international spotlight in view of the World Cup in 2014 and the Olympics in 2016. Brazil has a history of being inward-looking despite being largely made up of immigrant communities. But this is now changing. Brazil is encouraging external investment in its infrastructure and energy sectors. It's taking steps to boost the relatively low export share of the economy (less than 20% of GDP). And it has recognised its potential to build up links with Lusophone economies and other states in Africa.

The federal system and multiple layers of government complicate investment decisions. But Brazil is politically stable and relatively transparent, with large swathes of the public sector process visible online and subject to public and press scrutiny.

Brazil's stock of human is appealing for investors watching for growth of emerging market consumption. Availability of luxury goods rivals that in the wealthiest shopping markets in the world. Brazil has size, scale and sophistication which surprise many first-time visitors. Its demographic diversity is unmatched by any other country, including the US.

The country remains one of the world's most unequal societies. São Paulo has the world's largest helicopter fleet, yet millions still live in shanty towns. However we should not forget that 30m citizens have been lifted from poverty into the 'consumer' classes in recent years.

Brazil's abundant natural resources make it relatively resilient to global vicissitudes. The country has over 22% of the world's land available for agriculture. Large-scale resources in energy (both fossil fuels and renewable) and water give Brazil self-sufficiency as well as great potential for foreign investors. With a world-class agricultural research body (Embrapa) Brazil is regarded as a key factor for global future food supplies.

There are plenty of negative points. Chronic under-investment in recent years has led to crumbling infrastructure. Power shortages, traffic congestion and absence of sufficient public transport are general features of most Brazilian cities. (There are some notable exceptions, such as Curitiba's integrated transport system.)

A recent survey on the ease of doing business put Brazil in the bottom third of global markets. The quality of education and healthcare is below the standard expected of a country where the public sector takes up nearly 40% of GDP (much of which is accounted for by a generous and outdated pension system). Business leaders constantly urge reform of labour laws and the taxation system. This will be essential if Brazil is to improve its productivity to become competitive in global markets.

However bright spots prevail. In São Paulo state – accounting for over a third of Brazilian GDP – world-class roads connect the metropolitan city of São Paulo to a range of large and wealthy cities in the interior. The state recently has announced $20bn of investments in public private partnerships thorough eight projects covering transportation, healthcare, and prisons, which could be highly attractive for foreign providers of capital.

Reinvigorating surveillance

Better appreciation of systemic risks

Taline Koranchelian and Alison Stuart, International Monetary Fund

The International Monetary Fund is refashioning its surveillance mechanisms to improve monitoring of global, regional, and national economies and policies. The aim is to ensure they respond to the needs of its 188 members and are consistent with countries' and regions' own interests and those of the wider international community.

The policy shift recognises that the Fund's effectiveness greatly depends on the quality and influence of its monitoring efforts. A central lesson of the financial crisis has been that Fund surveillance for crisis prevention needs to be much more rigorous, with a better appreciation of systemic risks and cross-border spillovers, and a greater focus on financial stability issues and macroeconomic linkages.

Until the crisis of 2007-08, the bulk of the Fund's efforts were at country level, with limited treatment of spillovers in bilateral surveillance. In parallel, the Fund's assessment of the international monetary system was mostly based on analytical work rather than engagement with members regarding the spillover effects of their policies on other countries.

Following a comprehensive review of how the Fund can improve the effectiveness of its surveillance, it has launched three initiatives to improve its ability to be an effective guardian of global macroeconomic and financial stability. These are the Integrated Surveillance Decision, the Pilot External Sector Report, and the Financial Surveillance Strategy.

The Integrated Surveillance Decision, approved by the IMF Executive Board on 18 July 2012, enhances the Fund's ability to assess systemic risks. With this move, annual consultations with countries (known as Article IV consultations) have become a vehicle for integrating bilateral and multilateral surveillance.

These consultations are now expected to pay more attention to macrofinancial linkages, spillovers, and systemic issues, thus helping adapt Fund surveillance to the needs of an increasingly interconnected world.

Placing more emphasis on spillover analysis will raise the depth and relevance of Fund analysis, and also improve the traction of Fund advice. This should help increase the Fund's ability to detect vulnerabilities in and risks to member countries at an early stage, to assess their impact on global stability, to engage members in dialogue about these vulnerabilities and risks, and to provide timely policy advice. The objective is to help member countries take appropriate measures before potential problems evolve into major crises.

A challenge for Fund surveillance hitherto has been a perceived asymmetry, emanating from the widespread belief that large, powerful countries with crucial influence on the rest of the world get an easier time than smaller ones. Increasing the Fund's focus on spillovers in consultations with systemically important countries can help mitigate this perception, improving Fund members' overall ownership of surveillance and helping raise the traction and legitimacy of Fund decision-making.

By engaging both the countries that cause spillovers and those that are affected by them, the Fund can help foster policy coordination among member countries.

The second set of measures, through a new Pilot External Sector Report and supporting methodology, allows the IMF to strengthen its assessment of economies' external positions: movements in exchange rates, current accounts and capital flows. These assessments remain a central element of the IMF's work today, just as when the Fund was set up in 1944. The measures enable the IMF to look at all the large economies simultaneously and consistently, with a view to assessing whether the policies driving an economy's external position are leading to external imbalances.

Until 2007-08, the bulk of the Fund's efforts were at country level, with limited treatment of spillovers. The Fund's assessment of the international monetary system was mostly based on analytical work rather than engagement.

The Pilot Report finds that, while global imbalances have narrowed significantly since the onset of the financial crisis, the majority of the narrowing reflects economic downturns in deficit countries rather than improvements in policies. Without improvements in policies, external imbalances are likely to widen as the recovery gets underway.

Medium-term policy actions are thought to be needed across many economies, for three basic reasons:

- Large fiscal deficits in major advanced economies are exterting a major impact on external positions in other countries, perhaps adding as much as 1.5% of GDP to current account surpluses in other economies. While easy money among 'core' advanced countries has probably supported global activity, it has also driven capital flows that have complicated policies elsewhere, especially in emerging markets.
- External imbalances are being driven by sustained reserve accumulation in a number of emerging markets where foreign reserves are already more than adequate for precautionary purposes. According to the Fund's reserve-adequacy metric for emerging markets (a weighted average of the ratio of reserves to exports, short-term foreign debt, portfolio liabilities, and the money supply), reserves are above the level justified for precautionary purposes in almost half of emerging markets.
- Structural policies are likely to be important in facilitating adjustment and reducing imbalances over time. Such policies call for further progress in strengthening financial regulation and supervision in advanced economies; comprehensive labour and product market improvements to boost productivity in the euro area (particularly in deficit economies); and changes in the level of social protection in China.

The IMF is looking for feedback on the new Pilot External Sector Report and External Balance methodology so that they can be refined in 2013. (See details below.)

A third element of improved surveillance encompasses a financial surveillance strategy to guide the IMF's work in an ever more complex field. Financial deepening and globalisation have brought important benefits, but the increased scale, pace and complexity of financial flows and connections across financial systems require greater vigilance.

The strategy has three pillars:

- Improving risk identification and macrofinancial policy analysis. Highly interconnected financial systems can cause shocks to propagate rapidly across countries. So it is crucial that the IMF continues to deepen its understanding of the nature and implications of cross-border linkages, vulnerabilities, and spillovers. Work will continue on examining the effectiveness of macroeconomic and macroprudential policies and assessing the implications of global regulatory reforms now under way.
- The IMF is upgrading the way that financial surveillance is included in country analysis (for example through the Fund's Financial Sector Assessment Programme) to ensure that insights are fully distilled and follow-up occurs. This will be supported by building greater expertise on these issues throughout the IMF's staff.
- The IMF is engaging key external bodies more actively with the goal of promoting an earlier diagnosis of systemic risk. This involves deeper collaboration with groups such as the newly established risk boards, the Financial Stability Board, the G20, the World Bank and standard-setting bodies.

All these measures will help the IMF to spot and combat nascent sources of vulnerability at an early stage. Most importantly, this will assist the IMF in accomplishing its central mission of helping guide policy-makers to take action to help mitigate or avert future crises.

The views expressed in this article are those of the authors and should not be attributed to the IMF, its Executive Board, or its management. For further details please refer to http://www.imf.org/external/np/pp/eng/2012/071712.pdf); http://www.imf.org/external/np/spr/2012/consult/esr/; http://www.imf.org/external/np/pp/eng/2012/082812.pdf).

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Why the dollar will remain dominant

Renminbi rises in '1+4' currency system

Jin Zhongxia, The People's Bank of China

For the foreseeable future, we can speak of the global currency system as a framework of '1+4'. The dollar will continue to be the super reserve currency, supplemented by four smaller reserve currencies: the euro and the British pound in Europe, and the Japanese yen and the Chinese renminbi in Asia.

The dollar's global dominance will continue, reflecting US economic, financial and military power. The dollar's superiority over the other currencies, particularly the second largest international currency, the euro, is rooted in its economic structure.

The euro area is similar to the US economy in size. But the euro area's factor mobility, fiscal integration and, as a result, its ability to deal with any structural crisis is not comparable with that of the US. The US economy is not merely stronger than that of the euro area by itself. In addition, it also enjoys the existence of an unofficial dollar zone.

The US economy is not merely stronger than that of the euro area by itself. In addition, it also enjoys the existence of an unofficial dollar zone.

Those countries in the world that rely on the dollar for most of their international transactions and hold dollars as major international reserve asset all belong to the de facto dollar zone.

Compared to the euro area, the dollar zone has much greater resilience to shocks. This is because the exchange rate between the dollar and the other currencies are mostly not fixed and can be adjusted when necessary.

The dollar zone looks much more loosely connected, but in reality it is more coherent than the euro area, despite the official commitment of the euro member states to that currency. In most cases, the US doesn't have any official obligation to support those de facto members in their efforts to carry out structural adjustment.

The Federal Reserve occasionally provides liquidity support to other offshore dollar centres though swap agreements. Frequently, the US can transfer its financial burdens or the cost of its own financial problems to the other unofficial members.

In addition, countries in the dollar zone use a common financial infrastructure such as the cross-border payment and messaging system dominated by the US. Even the euro and the pound rely on some of these systems.

The dollar zone looks like currency federalism, a unification based on free choice. In reality, the constraint on its members is much stronger than that which would come from federalism.

Theoretically, members of the dollar zone can freely choose their reserve currency. But, in reality, the construction of an independent international payment and messaging system, other than the one supplied or dominated by the US, is too costly for ordinary countries. Therefore, for most countries in the world, there is no choice other than the US dollar.

In the medium term, the value of the dollar may tend to be stabilised and even recover, especially considering that the currency's depreciation in the past few years has promoted American exports.

Furthermore, increased domestic energy production will lead to an improvement in the US balance of payments and a strengthening of the dollar in future.

The debt crisis in the euro area has demonstrated the structural weakness of this currency. If we take into consideration that the euro partially relies on the dollar's payments infrastructure for its cross-border transactions, we can say that the euro is basically a very large regional reserve currency.

But the sheer size of the euro area economy and financial market, together with its highly-advanced science and technology, will maintain the euro as the second most important international currency, behind only the dollar, in the foreseeable future. In fact, the weakening of the euro during the crisis has benefited core countries such as Germany and France by protecting their manufacturing sectors' competitiveness.

The British pound will continue to be an important player with very special vitality and unique importance. The British empire no longer exists. But London, being located in the middle of the east and west time zones, is still the most important international financial centre, comparable to New York in many aspects.

The British pound will continue to be an important player with very special vitality and unique importance. London is still the most important international financial centre, comparable to New York.

London has advantages in financial freedom and openness, in foreign exchange trading, international bond issuance and financial derivatives. London is the world's most important offshore financial centre. Notably, the benchmark interest rate of the dollar is determined in London rather than New York. We have Libor, not Nibor.

Although many people believe that Japan has been not very successful in promoting the yen's internationalisation, the yen is still the most internationalised currency in Asia. It is very likely to continue as such in coming years. Yen settlement accounts for 30-40% of Japan's total foreign trade, a level that China will take years to catch up.

Several factors are likely to help the yen keep its leading role in Asia in the next decade. These are its full convertibility on capital account, its higher degree of openness in financial markets compared with most of its neighbours, its persistent low interest rates and the promotion of official Japanese overseas development assistance, credit and investment.

The internationalisation of the renminbi has been a hot topic in recent years. In fact, the renminbi has lagged behind the yen in Asia for many years, not to mention the other major currencies.

But the Chinese currency has great potential. The degree of China's domestic market integration and factor mobility is comparable with that of the euro area, although it is lower than that in the US. China's fiscal integration is not only higher than in the euro area, but also higher than in the US.

The size of the Chinese economy will catch up with the US and the euro area in one or two decades. To some extent, the process of renminbi internationalisation is determined not by how much we export the renminbi to the offshore market, but rather by the size, openness and competitiveness of the Chinese economy.

An international currency system that is properly tiered among multi-polar segments can benefit global economic stability. But we must bear in mind that the cross-border usage of the renminbi is aimed, mainly, at dealing with some problems in the Chinese economy.

Internationalisation of the renminbi can reduce the country's currency mismatch, so that a more flexible exchange rate adjustment will not generate unexpected shocks to the real economy, and any external imbalances can be corrected in a timely and effective manner.

From the viewpoint of developed countries, the cross-border usage of the renminbi can satisfy three sets of requirements. It can meet demand for liquidity in China-related international transactions, diversify currency risk, and help reduce the burden on other central banks to provide liquidity to the international financial market.

That will in turn enable the stimulative monetary policy in these countries to boost their domestic economies, rather than creating bubbles in the rest of the world. Therefore, the internationalisation of the renminbi, based on market choice, will contribute to the stability of the international monetary system.

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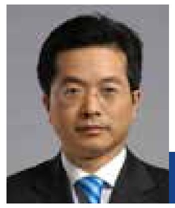


Locked in euro straitjacket

Five lessons from Europe's debt crisis

Miao Jianmin, Chief Executive, China Life Asset Management

The European sovereign debt crisis should be interpreted as a crisis first of the European economy, then of its fiscal system, and finally of the euro currency itself. After joining economic and monetary union (EMU), southern European countries enjoyed much lower interest rates than they deserved.

Before the crisis broke out, the treasury yield spreads between the highest- and lowest-priced countries of the euro area, including southern members such as Greece, Spain, and Italy, were within 50 basis points.

Such a pricing mechanism of sovereign risks was obviously distorted. Low borrowing costs eased the way for southern European countries to increase expenditure rapidly without any enhancement of their competitiveness. In southern economies like Greece, Italy, and Spain, unit labour costs at one time exceeded German levels.

The Germans have unforgettable memories of the devastating impact of inflation. They are very wary of any loose monetary policy from the European Central Bank.

Locked in a euro straitjacket, the southern European countries were not able to resort to devaluing their currencies to restore competitiveness. This triggered a series of crises that morphed into different forms at sequential stages.

To solve the crisis, there are four possible options. The first is through inflation. This befell the post-First World War Weimar Republic, when the German government chose to inflate its way out of its enormous debt resulting from the unbearable burden of war reparations.

The Germans have unforgettable memories of the devastating impact of inflation. As a result, they are very wary of any loose monetary policy that may be launched by the European Central Bank (ECB), and will certainly not favour following an inflationary path to alleviate the debt burden.

The second route is through economic growth. When growth accelerates, so do tax and fiscal revenues – producing solvency for the public debt position. As defined by production function theory, economic growth is related to three input factors, namely technology, labour and capital.

In recent years, southern European countries have made little progress in technology. Meanwhile, their population has continued to age with rises in dependency ratios and in average age of workers. Their banks, busy with balance sheet deleveraging, are more willing to hold on to their reserves rather than extend loans.

Consequently, even if the two variables of labour and technology remained unchanged, weaker credit supply would lead to shrinking investment, which could in turn weigh on both industrial output and economic growth.

If the first two options are not feasible, the third way is outright default. The Greek debt restructuring is de facto default. It was done in the name of 'voluntary debt restructuring', an attempt to avoid a credit event triggering payouts under Credit Default Swap arrangements.

The fourth option, if default is not seen as feasible, is to use transfer payments to repay debts. The EU's bailout packages to the periphery represent a kind of transfer payment. However, for such payments to be available in the long term, the transfer mechanism should be built with, and run by, a formal fiscal union.

For example, long term fund transfers from eastern China to the country's west are only viable when the two regions are in the same fiscal framework. When applied to euro members, such a framework requires a fiscal union. Further ahead, a political union is needed to make the fiscal union sufficiently stable and solid.

With the debt crisis now affecting several of its members, the EU seems to have failed to accelerate its course towards a fiscal union, even moving backwards in some regions. In the Catalan elections in Spain, most seats were won by parties in favour of autonomy and even independence.

The slow progress of forging fiscal union posts a big challenge to successful tackling of the debt crisis. Long-term transfer payments and universal budgeting cannot be made without a unified fiscal and political system.

A banking union, as much talked about recently, will not be sufficient to replace the fiscal union and resolve the debt issues.

Long-term transfer payments and universal budgeting cannot be made without a unified fiscal and political system. A banking union will not be sufficient to replace the fiscal union and resolve the debt issues.

Europe's difficult experience with its public finances offers the rest of the world five cautionary lessons:

- A country's welfare expenditure should be in line with its fiscal and economic strength. In a democratic political system, to secure more votes during election campaigns, politicians often have to promise better welfare and tax cuts.

  Such promises, in aggregate, add to the ever-rising standard of welfare, which may far exceed the pace of economic and revenue growth. The outbreak of the debt crisis was ignited by the long-term funding gap between generous welfare and limited fiscal revenue. This is a profound lesson that we must not forget.

- Keynesianism is not a panacea. In the past, the level of public debt was often raised to stimulate growth when the economy was on the brink of recession. However, governments around the world should not take any comfort from the way that debt accumulation doesn't appear to have any limits. When public debt reaches a certain level, further increases will not boost the economy. Instead, it will be dragged deeper downwards. In such scenarios, monetarism seems to have a limited role.

  The ECB's two rounds of liquidity injections through the LTRO programme did not result in loan growth. Nor did the Fed, after four rounds of quantitative easing, achieve its target of producing credit growth. In other words, you cannot rely on increased government spending to boost the economy. And monetary policy, in the long run, is neutral to economic performance.

- Demographic structure has a significant impact on macroeconomic outcomes, financial markets and government finance. An aging population not only lowers savings rates, creativity and productivity, but also slows economic growth and fiscal revenue.

  In addition, an aging society will cause financial assets to depreciate. Asset risk premium is positively correlated with the average age of the society; when the latter increases, the risk premium rises, depressing asset prices. This process is long term, gradual, and irreversible. When the debt spike in the southern European countries is coupled with an aging population, it is like rubbing salt into a wound.

- Monetary unions should be supported by fiscal unions. Otherwise the structural contradictions in monetary union are hard to unwind.

- Counter-cyclical measures are the key to preventing such crises, but are difficult to implement. These measures include tax increases during economic boom times, and tax cuts when the economy contracts. Compared with tax cuts, tax increases are much more likely to arouse social objections. This heavily impedes counter-cyclical management.

  The current fiscal and credit crunches across Europe make the environment harsher for counter-cyclical measures in southern European economies, in spite of their necessity. Therefore, political consensus and strong support should be ready before any measure is in place. This is easier said than done.

Japan closer to appointing 'deflation hawk' Iwata as next governor (... continued from page 1)

Abe stated in a Japanese TV programme that he would convene specialists to discuss the choice of central bank governor. Masaaki Shirakawa, the incumbent, who has been in the job for five years, has announced he is stepping down on 19 March, three weeks earlier than the expiry of his mandate in April, strengthening the financial markets' belief that we are due to see a change in policy.

At a recent lunch at Abe's official residence to discuss monetary policy, I found myself in the company of Abe and his finance and economic ministers, as well as five economists, all noted deflation hawks; unlike an inflation hawk, a deflation hawk proposes aggressive monetary easing to combat deflation.

At the time of the lunch, his statement has not come to my knowledge. So I was surprised to see newspaper reporters waiting for me at the gate shouting: 'Who will be the next BOJ governor?' Usually, at this kind of meeting, Japanese bureaucrats select a group of specialists with divergent opinions, so that a conclusion will be reached somewhere in mid-range. Apparently I was selected because of my moderately hawkish stance on deflation. I was there to offset the bureaucrats' apparent fear of a 'reign of terror' by anti-deflation extremists. This tells us a great deal about how far the mood has shifted in Japan in recent months.

Abe instructed us not to reveal what was discussed, but he did not tell us we shouldn't reveal what was not discussed. So let me use some discretion.

Abe did not raise the issue of the new governor, probably because he didn't need to.

The new governor must be approved both by the Liberal Democratic Party, which took over the reins after Abe's December election victory, and the Democratic Party, the previous government party, which still controls the upper house of parliament. The two parties have almost certainly settled on a person such as Iwata, who fits both parties' tastes and is likely to be able to satisfy Abe's wish to 'jump start' the economy.

The latest accord between the government and the Bank of Japan requires the central bank to purchase exactly the same volume of treasury bonds this year as was announced previously. But markets have been sufficiently influenced by Abe's election that Japanese stock prices have increased by 30% from last November.

Present circumstances have produced some unexpected outcomes. Abe's election has opened up a new wave of foreign and domestic interest in Japanese stocks. Japanese securities companies have had to make considerable efforts to increase equity-orientated sales personnel, where staff numbers have been cut in recent years because of lack of demand. Securities companies previously specialised increasingly in mutual funds incorporating foreign government bonds. Now, for the time being at least, all that has changed.

Soft landing (... continued from page 1)

University spokesperson Martin Mbugua said Princeton cannot comment on the search for a new president. 'We will make an announcement in the spring,' he said.

If Bernanke ends up back at Princeton, he could indulge in some reminiscing with another veteran of the financial crisis, the outgoing Bank of England Governor Mervyn King, who may soon be appointed visiting professor at the university.

A 17-person search committee headed by Kathryn Hall, chairman of the Board of Trustees, was empaneled in October. The final decision will be made by the trustees. Mbugua said it was possible there could be an interim period between Tilghman's departure and the installation of her successor.

Princeton traces its foundation back to 1746 as the College of New Jersey. Its most famous president was Woodrow Wilson, who led the university from 1902 to 1910, before becoming governor of New Jersey in 1911 and president of the United States in 1913. Albert Einstein also made his home in Princeton for two decades after he left Nazi Germany, though he was affiliated with the Institute for Advanced Study there, an independent centre for postgraduate study that is separate from the university.

Tilghman, who took office in 2001, is a professor of molecular biology. Her two immediate predecessors, William Bowen and Harold Shapiro, were economists.

Paul Volcker, now 85, was Fed chairman from 1979 to 1987. He joined boutique investment bank Wolfensohn when he left the Fed. Alan Greenspan, now 86 and chairman from 1987 to 2006, formed a private consulting firm. Bernanke will be just 60 in January.

Quote of the month

'The sovereign crisis is tearing the system [EMU] apart ... States with the worst macroeconomic conditions are the ones with the highest interest rates... [EMU] has amplified heterogeneity rather than mitigating it.'

Athanasios Orphanides, former Governor, Central Bank of Cyprus and Member, European Central Bank Governing Council, Frankfurt, 7 February 2013.

Consequences of conservatism

Balancing security with shrinking pool of risk-free assets

Moorad Choudhry, Advisory Board

A more conservative approach to bank funding and liquidity risk management raises natural demands for more secured lending and more risk-free collateral. This shift is undoubtedly a positive reaction to the financial crisis. However, as in other areas of banks' balance sheets (see OMFIF Bulletin, January 2013, p.16), such changes can have negative unintended consequences, requiring a thorough review of the convential banking business model.

To give one example, one consequence of the crash was the call for the multi-trillion dollar derivatives market to settle through centralised clearing counterparties (CCP). This eliminates the counterparty risk inherent in the over-the-counter market and theoretically reduces systemic risk. The CCPs require over-collateralisation. As a result every CCP counterparty will observe an increased funding requirement over and above the market value mark-to-market (MTM) of their derivatives portfolio.

For banks collateralising a net negative MTM position, this needs to be addressed at the micro level via the firm's derivatives funding policy. A business best-practice approach when drafting such a policy would focus on correct funding charges to be levied against the derivatives business line, to generate accurate returns analysis. This would be part of the bank's liquidity risk management policy.

At the macro level there is a more systemic issue, focused on collateral passed over in the form of securities. In view of the relative paucity of genuinely AAA-rated sovereign issuers, part of the collateral passed to the CCP will consist of lower-rated sovereign and corporate bonds. In effect, the CCP in itself becomes a concentration of centralised credit risk. The CCP may seek to mitigate this risk through over-collateralisation. But a market crash could lead to losses even at relatively conservative levels of bond 'haircuts', to say nothing of the impact on liquidity of such bonds in a stressed environment.

One way to remove potentially significant credit risk at a CCP will be to require purely cash collateralisation. But this may have wider economic implications, such as reduced bank lending capacity.

One way to remove potentially significant credit risk at a CCP will be to require purely cash collateralisation. But this would generate funding and balance sheet effects with wider economic implications, such as reduced bank lending capacity. Another concern stems from the call for higher levels of secured funding, a reaction to the freeze in unsecured interbank markets in 2008-09. A greater share of secured funding on a bank's balance sheet, provided the collateral is of sufficiently high quality, should create a more stable funding model, since such funding lines are less likely to be withdrawn in case of stress.

However this trend also produces asset encumbrance. An orthodox banking model assumes a certain level of unsecured borrowing (unlike, say a hedge fund model). An increasing level of encumbrance would result in a higher loss given default (LGD) for a bank, with consequent impact on both Tier 2/senior unsecured funding rates and credit rating. The issue is made more complicated by the requirements of 'bail-in' debt. If more of banks' forthcoming senior unsecured debt is required to be 'bail-inable', while at the same time the overall share of unsecured funding is falling, funding becomes more expensive and unpalatable for investors. Paradoxically, although the bank may be deemed more stable, the overall balance sheet funding cost can increase.

Changes in funding structure and increased collateral requirements make it urgent to review a bank's entire business model. Banks are like supertankers: changing strategic direction to accompany shifts in balance sheet structure takes time to accomplish. While the end-result should be a more stable liquidity and funding model and hence banking industry, the transition period may prove difficult for many parties.

This is Part 2 in a series of articles on bank liquidity. Professor Moorad Choudhry is Acting Head of Strategy and Regulation at RBS Group Treasury, and a member of the OMFIF Advisory Board. The views and opinions expressed herein are solely those of the author.

Riskier outlook for safe havens

US housing recovery will steepen yield curve

Trevor Greetham, Advisory Board

As the prospects for risk assets improve, they dim for safe haven investments like bonds, gold and the Swiss franc. The recovery in US housing could lead to significant yield curve steepening and losses for holders of long-duration US Treasury bonds. Sustained recovery could lead to a major shift from gold to copper. The Swiss franc could follow the yen's weakening trend if a global recovery pushes the euro crisis into remission once more.

The recovery in US housing makes earlier than expected Fed tightening a credible risk. Significant yield curve steepening would see losses for holders at the long end in a repeat of 1994.

Within fixed income portfolios, the high yield category looks likely to be the asset class that will perform best.

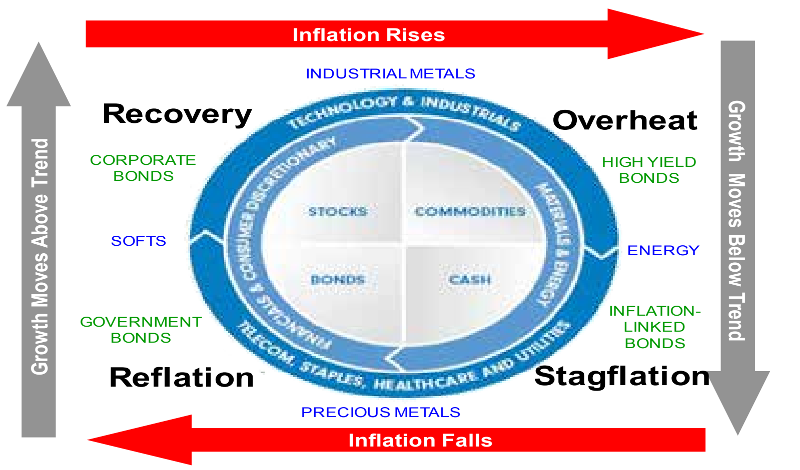
The Investment Clock model (see Chart 1) that guides Fidelity's asset allocation decisions is moving into the disinflationary Recovery phase (see Chart 2). The firm's global growth scorecard turned positive in December for the first time since June as the OECD's lead indicators bottomed out. So far the global inflation scorecard continues to point downwards with ample spare capacity, commodity price weakness and inflation downgrades pointing to a muted outlook for prices.

Central banks are in no mood to slam on the brakes, even if the Investment Clock moves back into the Overheat phase. The Fed will tighten only after significant further falls in unemployment (see Chart 3). The Bank of Japan is about to embark on additional easing with the aim of creating inflation. The Bank of England's governor-in-waiting favours what he calls 'flexible inflation targeting', factoring in the potential for a significant overshoot in inflation if wider economic considerations warrant it.

There are even signs monetary policy is gaining traction in the euro area where capital is flowing back to the periphery and an expansion in the real M1 money supply points to economic recovery in 2013, contrary to consensus forecasts. As the prospects for risk assets improve, they dim for safe haven investments like bonds, gold and the Swiss franc. Government bond yields are artificially low. The recovery in US housing makes earlier than expected Fed tightening a credible risk. Significant yield curve steepening would see losses for holders at the long end in a repeat of 1994.

The gold price has risen dramatically in recent years on the back of economic uncertainty, dollar weakness and negative real interest rates. Sustained recovery could lead to a major shift in favour of industrial metals like copper while an eventual normalisation of US interest rates would trigger a more meaningful correction.

Chart 1: Fidelity Investment Clock



Euro break-up fears saw the Swiss currency rise 60% against the euro before the Swiss National Bank intervened to impose a floor of 1.20. Yen strength has reversed and the strong performance of peripheral euro bonds suggests the Swiss franc could follow suit, especially if global recovery pushes the euro crisis back into remission.

Yen strength has reversed and the strong performance of peripheral euro bonds suggests the Swiss franc could follow suit, especially if global recovery pushes the euro crisis back into remission.

Within fixed income portfolios we continue to favour high yield bonds. Spreads have narrowed substantially since 2009 but they remain in line with the long run average. In a multi asset portfolio we prefer equity exposure. Equities offer more upside potential in a period of risk asset strength and they could see valuation shift in their favour.

Much of the impressive outperformance of the high yield asset class since the dotcom bubble can be explained by the de-rating of equities over this period.

With Fed policy set to remain easy long into an upturn, rising inflation expectations are likely to put upward pressure on bond yields. Meanwhile, equities look set to benefit as improving nominal earnings expectations lead to an increase in valuation multiples.

Chart 2: Clock trail in recovery

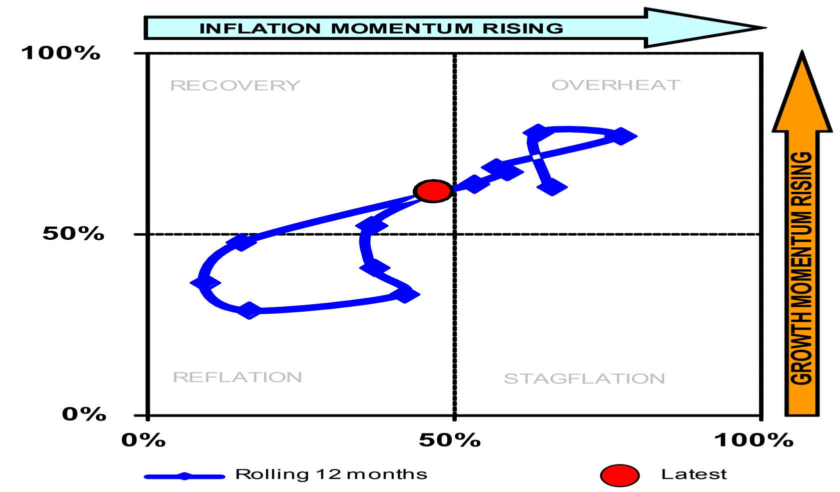
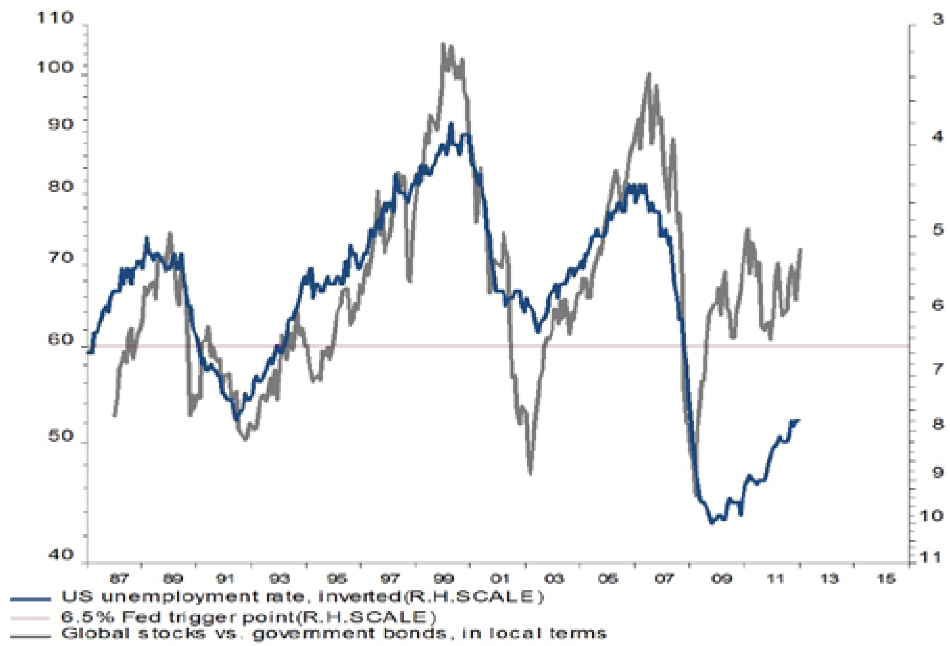


Chart 3: US unemployment rate (inverted) and global stocks vs. bonds



Dangers of a wider interpretation

Argentina ruling could create financial market problems

Allen & Overy Global Law Intelligence Unit

The case of NML Capital Ltd v Argentina decided by a US Federal court of appeals in New York in October 2012 held that Argentina violated a standard pari passu clause in its old unrestructured bonds. Argentina was ordered not to make any payments on new bonds unless it made a rateable payment to the holders of the old bonds.

The new bonds had been exchanged for most of the old bonds in 2005 and 2010 pursuant to the restructuring of Argentina's foreign debt.

The court held that the reasons for the violation were a combination, among other things, of a statute passed by Argentina preventing Argentina from paying the holders of the old bonds as holdouts, declarations by Argentina that it would not pay the holdouts and the persistent non-payment of the holdouts for six years.

The pari passu clause typically provides that the bond debt will rank pari passu with other debt or, in the case of sovereigns, other external debt. It is a standard provision in international sovereign and private sector bonds.

One of the reasons the case is important is because of the consequences of adopting one of the two main competing interpretations of pari passu clauses, the narrow interpretation and the wide interpretation.

The narrow interpretation holds that there is a breach of the pari passu clause only if the debtor subordinates the protected debt by some legal or mandatory measure which changes the legal ranking.

The wide interpretation holds that once a debtor is in fact insolvent or in payment default, it cannot actually pay any of its debts without a rateable payment of other debts within the scope of the pari passu clause.

The narrow interpretation, which accords with the mainstream market understanding of the clause, does not normally give rise to problems: the clause is treated as boilerplate because sovereigns very rarely change the ranking of their obligations by specific statutes.

The wide interpretation, however, would prevent sovereigns and indeed other corporate or bank debtors from making any unequal payments when they are in fact insolvent or even just in any kind of payment default.

This could inhibit payments to preferred creditors such as multilaterals or to creditors where it is desirable in the interests of stability of the markets or of the protection of a corporate debtor's business.

It is unclear which interpretation the court sided with although it held that Argentina's overall course of conduct was sufficient to allow the court to reach its decision.

In doing so the wider interpretation seems to be the preferred one but not with sufficient discussion of the issues and clarity of principle and policy.

Accordingly, there is uncertainty as to what the court intended and the possibility of destabilising litigation.

Although the decision is a decision on bonds governed by New York law, a decision by a senior court in New York might influence courts elsewhere and could, in any event, affect bonds not governed by New York law.

Although the decision is a decision on bonds governed by New York law, a decision by a senior court in New York might influence courts elsewhere and could, in any event, affect bonds not governed by New York law.

If the wider interpretation were adopted, then this could have disruptive implications for work-outs and the resolution of financial difficulties in the case of sovereign debtors and private sector debtors. The use of collective action clauses could mitigate the problem of holdout creditors but the protections would not be comprehensive.

The case is also important because, instead of just leaving the creditor to its ordinary remedies for a default, the court made a tough order compelling Argentina to make rateable payments to the creditor if Argentina paid the new bonds.

The case is important because, instead of just leaving the creditor to its ordinary remedies for a default, the court made a tough order compelling Argentina to make rateable payments to the creditor if Argentina paid the new bonds.

Some commentators have said that the cases is to be welcomed because the ruling strengthens creditors' rights against a sovereign state which is able but unwilling to pay and that the ruling delivers a message to the more aggressive defaulting states that the courts can get tough.

However, the case needs also to be viewed outside the saga of the Argentina litigation and in the wider context of the debt markets. A pari passu clause is standard in virtually all major international bonds and bank syndicated credits so that the amounts involved probably run into trillions of dollars or the equivalent.

The wider interpretation suggested by the New York courts appears to be contrary to the intentions of the parties and would therefore create considerable instability in financial markets.

It would give individual creditors the possibility of very unexpected events of default. It would effectively give individual creditors a veto right during restructuring negotiations because inevitably during restructurings, both corporates and sovereigns have to be able to keep making some payments in order to keep going.

Indeed, it is desirable in the interests of a rescue that they should, e.g. payments to employees and trade payments and rent in the case of corporates and essential payments in the case of sovereign states. The debate on the ambit of the pari passu clause has been running since around 2001 following a case in Belgium.

It is highly desirable that US courts, as the custodians of one of the most important legal systems in the world used as a public utility in relation to very large financial contracts, should settle this issue with clarity, certainty and regard for the operations of the debt markets as a whole.

The public interest would be served if such a settlement were to be made in favour of the narrow interpretation. The wider interpretation of equality of payment would have unintended consequences and would destabilise the vast debt market where the pari passu clauses are prevalent. Clauses requiring equality of payment are extremely rare in financial practice and are, in our view, not contemplated by the standard pari passu clause. If parties wish to insert clauses about equality of payments, as opposed to legal ranking, it is open to them to do so.

This article forms the Executive Summary of 'The pari passu clause and the Argentinean case' produced by the Allen & Overy Global Law Intelligence Unit, December 2012. The full report is available from melissa.hunt@allenovery.com

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Repairing the euro's flaws

Strengthening integration for Portuguese success

Carlos da Silva Costa, Governor, Banco de Portugal

Today it is clear that the architecture of economic and monetary union (EMU) was flawed and incomplete from the start. The set-up was incapable of ensuring economic and financial stability when exposed to abrupt changes in market uncertainty and risk perception. These flaws have heightened the difficulties faced by some member states, which in turn explains why the contagion effects among euro area economies have surpassed expectations.

European investment projects with a proven impact on potential output are needed, for example in energy and telecommunications.

We urgently need to rethink the EMU model to ensure that the euro area is stable and resilient both to common and specific exogenous shocks and to risks of inconsistency among the policies of the various economies. The euro area's construction must be supported by stable and resilient pillars. Rules and institutions are needed to control the mutual interdependence between the stability of the whole and each of its parts.

Resolving the crisis and restoring sustainable, job-creating growth in Europe requires measures at a national and European level. The stability of the whole is endangered by lasting divergence or instability among one or several components. Likewise, stabilising the components depends on the nature of the impulses they receive from the whole.

The countries that registered significant past macroeconomic imbalances and faced market-based funding constraints need to adopt policies to restore public debt sustainability, financial stability and competitiveness, thereby recovering their credibility and confidence. This is the case for Portugal. The strategy established in the Portuguese Economic Adjustment Programme is crucial to eliminating macroeconomic imbalances and structural blockages. In spite of the considerable challenges facing the Portuguese economy and society, progress is clearly visible, particularly in the correction of the external imbalance.

Compliance with the adjustment programme is a necessary though insufficient condition to ensure the success of the adjustment process. Adjustment efforts at national level must be complemented by European-level initiatives. First, the quality of the rules and institutions governing the euro area and each of its parts must be sufficient to annul the risk of fragmentation and moral hazard. Second, mechanisms to ensure liquidity, and to monitor and encourage medium-term structural reforms must be combined with mechanisms to safeguard the stability of the financial system. Third, we need effective, ex ante macroeconomic policy cooperation and coordination to ensure the stability and growth of both the Union as a whole and of each member state.

Instruments to respond quickly and effectively to financial stability problems are now in place with the European Financial Stability Facility and the European Stability Mechanism. In addition, we must ensure that national policies complement each other. European investment projects with a proven impact on potential output are needed, for example in energy and telecommunications. These projects would buttress an integrated, efficient and competitive economy taking full advantage of the single market.

Building a new European institutional architecture rests on four pillars: banking union, fiscal union, economic union and the strengthening of democratic legitimacy and accountability. In ensuring progress in constructing these pillars, we must use high quality materials, so that the new edifice is structurally solid and shockproof.

We must promote, on the one hand, the notion of common interest and willingness to minimise moral hazard; and, on the other, policies aligned with the stability and economic growth objectives. We need group efficiency and cohesion. Each member can scrutinise the manner in which the objectives pursued by the group are established and implemented. This is a condition for accepting the overall constraints. Such a framework makes it possible to recover, under shared sovereignty, necessary losses of individual autonomy.

The importance of mitigating moral hazard cannot be underestimated, given that it may obstruct mutual aid and solidarity among member states. This requires rules for participation and mechanisms and institutions for monitoring compliance.

As we move towards more integrated fiscal and economic policies, we need mechanisms ensuring democratic legitimacy and accountability.

To overcome the European crisis, we must implement a new institutional framework for mutual confidence, involving mandatory deepening of financial, fiscal, economic and political integration. Banking union represents a key pillar for solving financial fragmentation and breaking the link between sovereigns and banks. Solely for geographical reasons, euro area corporations with similar profitability and risk profiles face different credit conditions.

A complete banking union encompasses three elements: a Single Supervisory Mechanism, applicable to all credit institutions, involving centralised decision-making and decentralised implementation; a Single Deposit Guarantee System; and a Single Resolution Mechanism.

The Single Supervisory Mechanism was recently approved by the EU Council, under which the European Central Bank (ECB) shall be responsible for carrying out supervisory tasks in the euro area, under coordination between the ECB and the national supervisory authorities, depending on the size of banks and national banking systems.

With all banks in the euro area under unified supervision, responsibility for deposit guarantee and resolution shall be held at the level where supervisory powers are exercised, i.e. at the European level. If a single supervisory mechanism is not accompanied by European deposit guarantee and bank resolution mechanisms, banking union will still be under construction and there will be an incomplete separation between sovereign and banking risk.

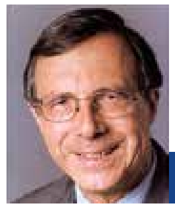
On the issue of fiscal union, lack of fiscal discipline among euro members during the pre-crisis period revealed the need to strengthen the institutional framework. Important decisions have already been taken, involving a range of regulations to promote fiscal discipline, but work for the construction of that pillar is still under way.

A genuine economic union requires an institutional framework to assess, coordinate and monitor member states' economic policy measures and reforms. Special emphasis should be placed on areas with a potentially higher impact on competitiveness, economic growth and employment, simultaneously promoting social cohesion. Members' economic policies and macroeconomic imbalances are of common interest. They require a concerted response. The 'European Semester' and the 'Euro-Plus Pact' are important improvements.

At the same time as we move towards more integrated fiscal and economic policies, we need mechanisms ensuring democratic legitimacy and accountability. This political dimension is crucial, and must reconcile the need for a legitimate response vis-à-vis 'the whole'; and the need to ensure that all parts, irrespective of their size, are represented and participate in the decision-making process.

In particular, the so-called 'community method' must be revitalised, in tandem with restoring the European Commission's central role, by strengthening its effectiveness and legitimacy. The political pillar, although being built alongside greater financial, fiscal and economic integration, has its own time-frame. The construction of the other pillars cannot be delayed for the launch of the work on the strengthening and reconstruction of the political pillar. The time criticality of the problems requires prompt responses to EMU's flaws. These are likely to be a catalyst for responses of political organisation and legitimacy that are less grandiose, but certainly more efficient.

European development is very important for the success of Portugal's adjustment. Determined domestic action is essential but not enough. The quality and vigour of the new mechanisms and institutions are crucial to strengthening market confidence. They are an indispensable complement to national adjustment effects. There is a virtuous relationship between the frontloading of national adjustment and the frontloading of the European integration process. Citizens must understand that new regulations and mechanisms are not the result of some external imposition. Rather, they are inherently necessary for a successful EMU and for the prosperity of Europe and each of its member states.



Russian roulette over EU

UK plan leads Europe into a maze

Laurens Jan Brinkhorst, Advisory Board

British prime minister David Cameron's speech calling for a referendum on EU memership appears to confirm traditional UK views on its relations with Europe. Sir Winston Churchill stated shortly after the war: 'We are with Europe and not of Europe.' Nothing new under the sun.

In his masterful book This Blessed Plot (1998), Hugo Young stated that during the last 60 years 'Britain (has) struggled to reconcile the past she could not forget with the future she could not avoid'. These words indeed reflect current British ambivalence towards the EU.

It is disingenuous for Cameron to suggest that the UK has somehow been surprised by the developments of its 40 years of membership. In 1973 the UK knew it joined a Community with a political objective and not simply a common market. From the very beginning the EC treaty called in its preamble for 'an ever closer union.' These words are binding on the UK as on all 26 other member states. Systematically the UK has tried over the years to neutralise this view, but despite its current setbacks the EU in 2013 is a stronger and more comprehensive organisation than at the time of its creation.

Cameron suggests that the single market and not the euro currency is the foundation of the EU. But this flies in the face of Article 3 of the Lisbon Treaty, which confirms that the euro is the currency of economic and monetary union (EMU) and therefore an essential part of the acquis communautaire. The UK has signed up to this text, although it has had an opt-out on adoption of the euro.

The prevailing euroscepticism in the UK is so strong because of hesitant and contradictory leadership statements over 40 years of UK membership. The true nature of the contract with Europe has never been put to the British population. In a sense the UK is now in the situation that chickens come home to roost! I say this without glee, since I believe in the need for a strong Britain in a strong Europe.

The prevailing euroscepticism in the UK is so strong because of hesitant and contradictory leadership statements over 40 years of UK membership. The true nature of the contract with Europe has never been put to the British population.

But Cameron's speech goes further than merely confirming 40 years of half-hearted EU membership. He adds a new dimension to the Russian roulette he's playing with the ultimate threat of termination. None of his predecessors went so far. When Harold Wilson renegotiated in 1975 within three years of adhesion, he obtained some minor concessions. But he never blackmailed his partners by suggesting that the UK might possibly leave. Even Margaret Thatcher, with her 'I want my money back' approach, didn't hold the other members to ransom.

As a result of Cameron's brinkmanship, the UK is entering a dangerous phase of uncertainty for a prolonged number of years, as deputy prime minister Nick Clegg correctly stated.

The British prime minister mentions three essential problems for the future of the EU. These are the euro crisis, lack of competitiveness and the increasing divide between the EU and its citizens. No one can disagree with this summing up, but given political will the current EU treaties are sufficiently flexible to meet these challenges.

These points, though, are not central to his concerns. Cameron hopes for a renegotiation with the other 26 member states to arrive at a different and looser relationship with the EU as a whole. Basically he wants to revert to the period prior to British membership. At the time the UK was leading the so-called Outer Seven, as a counterweight to EC's Inner Six, the original founding member states.

As a student of European history, Cameron must be aware that it was precisely the UK's 1960s political and economic decline that made necessary British membership of the customs union, which later became the internal market.

At present Cameron has not made any specific proposals for changing the existing treaties. The only thing we do know is that Cameron wants to modify the treaties in such a way that the eurosceptics in his party and the UK as a whole will end up in a minority position. However, the so-called five principles which he mentioned constitute insufficient guidance for concrete treaty texts. In a sense they are in the category of 'motherhood and apple pie'.

The British prime minister errs when presenting negotiations with his 26 partners as negotiations of his country with the 'EU', as if it were a foreign country. Of course all member states must agree with any modification of the existing treaties, but the UK should negotiate within the EU and not with the EU as a kind of external force.

Unlike at the time of the adhesion negotiations, the UK is now a full member. The EU as a system is based on a concept of give and take. It is a balance of mutual rights and obligations. This is true for every country, large or small, and has always been the essence of the integration process. Cameron cannot expect that, as the outcome of the negotiations, he can obtain a series of unilateral concessions applicable to the UK alone.

Even supposing that all member states agreed to modify the treaties, it is not inconceivable that one of them would fail to ratify the process. In such a situation the existing treaties would prevail. And the UK would continue to be bound by them: the converse of what Cameron wants to achieve.

Cameron also errs on another count: He wants above all to maintain an open and free internal market. He wants to achieve this with far fewer Brussels regulations. He invokes inter alia Dutch prime minister Mark Rutte in support. But this is another misconception.

None of the rules installed to create the internal market have been adopted without the specific approval of the Council of Ministers, above all by the Council of Competitiveness (of whose existence he does not seem to be aware).

It would indeed be welcome if some over-regulation in Brussels could be reversed, but the member states themselves are largely responsible for making such changes, which moreover do not require treaty modification.

At the same time many European rules are indispensable for the smooth functioning of the internal market without administrative restrictions on free trade.

As an example, at the time of the banking crisis, strong action, based on European legislation, was required to avoid discrimination – above all against British banks – on Irish territory as a result of unilateral subsidies that benefited only Irish banks. It would be a bizarre outcome if Cameron´s crusade for more flexibility in the EU resulted in a less free European market.

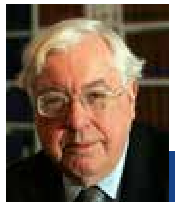
Many other legal and political uncertainties flow from Cameron´s speech on Europe. Let me cite just one. Even supposing that all member states agreed to modify the treaties according to his suggestions, it is not inconceivable that one of them would fail to ratify the process. In such a situation the existing treaties would prevail. And the UK would continue to be bound by them: the converse of what Cameron wants to achieve.

As a consequence there is a chance that Cameron's actions will lead the EU into a real maze. This would be a very bleak scenario, not just for the UK, but also for the EU as a whole. We need constructive relations among member states. Cameron's referendum plan will produce precisely the opposite.

We need constructive relations among member states. Cameron's referendum plan will produce precisely the opposite.

The wheel of history

How Cameron's move failed to stop western decline



John Kornblum, Advisory Board

When historians seek to understand the steady decline of the west in the 21st century, they may look back to 2012-13 as a turning point. The following indicates how a future historian may recount today's circumstances.

The first signs of confidence in 2013 were swamped by growing political immobility and spreading violence across the globe. No one had an answer for how best to organise the west to ensure that its vision of human society remained the operating system for an increasingly networked 21st century world.

At the beginning of 2013, three very different personalities became the focus of the debate. Newly re-elected US president Barack Obama soon found that his progressive vision of America's future could not overcome the anger of those left behind by globalisation. While German chancellor Angela Merkel remained her country's most popular politician, her unwillingness or inability to tell her voters where she was taking them began to wear away at her support. Her defeat in September started to look increasingly conceivable.

Some of these important shifts were crystallised by a seeming outsider, British prime minister David Cameron. His proposal in January 2013 for a referendum on British EU membership was rejected by most Europeans, even as they privately nodded their heads at much of his analysis. Even the American began to admit their warnings about the UK separating itself from the rest of Europe had been poorly conceived. The Cameron proposals stimulated a fundamental debate about the future direction of Europe. Even French president François Hollande, newly energised by his imperial adventure in Mali, joined the fray.

What happened to dampen the energy of the first months of 2013? The fear of decline was unable to overcome inertia on both sides of the Atlantic. Angela Merkel's creative push for a trans-Atlantic trade agreement was shelved by Barack Obama who considered it too hard to achieve. And as he said, with some resignation, 'After we negotiate hard for two years, the French will kill it anyway.'

Cameron began well with his challenge to Europe, achieved a notable success by teaming up with Merkel in February to peg the EU budget at 1% of GDP, but soon got bogged down by political pressure at home and abroad. Meanwhile basic contradictions at the heart of Merkel's strategy began to catch up with her. The fundamental weaknesses of the opposition Social Democratic Party (SPD) were masked by the resurgence of their past and future coalition party, the Greens, whose supporters represented a new German lifestyle.

By 2014, governments were looking nervously at parallels 100 years back. Waves of strikes, political separatism and market weakness swept regularly through Europe. Political battles continued in America, where the generation gap was made still more dramatic by pressures on Medicare and Social Security costs. Trans-Atlantic dialogue was reduced to mutual demands to 'fix' crises such as Iran, Syria and, once again, North Korea. The North Atlantic free trade zone was shelved. Cameron's demand for a real dialogue on the future of the EU was swamped by economic instability and the new German 'Stoplight' coalition of the SPD, Greens and the Free Democrats (FDP) demanding to prioritise German interests.

Europe continued to stagnate. Its world role declined still further. The UK voted narrowly in 2017 to stay in Europe, but turned its eyes more resolutely to the US and Asia. Market and demographic forces promoted a fall in the American budget and current account deficit, but America's own growing dysfunction was an increasing bar to global leadership. By 2020, the die was cast. America lived on its oil and gas exports. Europe debated yet another way to manage Chinese economic interference in its economies. The UK – hanging on to Scotland in the 2014 referendum, but made more heterogeneous by the new semi-independent Cornish and Manx republics – remained resolutely British.

What happened to dampen the energy of the first months of 2013? The fear of decline was unable to overcome inertia on both sides of the Atlantic.

Outrageous disparagement

Merkel won't favour Britain over France

Thomas Kielinger, Die Welt

The 24 January speech on Europe by UK prime minister David Cameron, proposing a referendum on UK membership of the European Union, carried some German overtones. I had the sneaking suspicion that its drafters might have included Angela Merkel, the chancellor. Ideas like competitiveness, flexibility or democratic accountability are as much part of her political vocabulary as they are of Cameron's.

To both Merkel and Cameron, 'more Europe' means more openness to reform to make the EU fit for global purpose. A German-British duet, not a duel.

But Merkel, while siding with Britain's prime minister on certain issues, cannot ignore the majority of her European partners and their criticism of British exceptionalism. Much of the German political class reacted with a mixture of bemusement, hauteur and outright scorn. Joschka Fischer, Germany's one-time foreign minister, deemed Cameron's ideas 'absurd'. On the website of Der Spiegel magazine, several authors made fun of Cameron's grandstanding: a country in Britain's economic difficulties can hardly pontificate to others.

Two national broadsheets, however, the Frankfurter Allgemeine Zeitung as well as my own Die Welt, begged to differ. Brussels would do well to listen to Cameron's message beyond its tactical domestic considerations, was their theme. Besides, how dearly Germans would love to have been consulted on the introduction of the euro, a colleague of mine wrote. Therein lies the rub. The chasm between so much of what one reads and what one hears among the under-represented vox populi is growing ever wider. That's why Cameron's speech has such an underground appeal amongst the populace in Germany and elsewhere in the European community.

Alas, that will not decide the outcome of his historical gamble. Rather, the question is whether Germany's traditional predilection for her 'English cousin' will withstand the slings and arrows of outrageous disparagements about 'British nay-sayers'. Put another way: will Angela Merkel be able to deliver on her promise to do her level best to keep Britain on board the European ship – and succeed in her efforts?

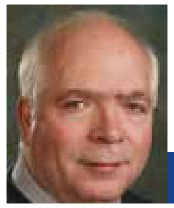
How we have laboured in pursuit of the Anglo-German liaison amiable since 1945. None more so than our first post-Second World War chancellor, Konrad Adenauer. At the height of the ratification procedure of the planned European Defence Community (EDC) in 1953 he addressed his party thus: 'I should very much welcome Britain having a certain influence in the future EDC so that we are not left alone with the more or less hysterical French.'

Nobody would use such un-spun political language nowadays. Political correctness forbid! And yet not wanting to be left 'alone' with Paris is a Leitmotif of many German European deliberations since the war. We feel more akin to British liberalism and free-trade instincts than to the more statist, protectionist French.

Ultimately, Germany will most likely not follow her liking for Britain if the price to pay is to separate her institutionally from the French. Integration towards closer fiscal union among euro members will come first – with or without changes to existing EU treaties. British hopes for repatriation of certain legislation to London will come second. This holds true even if Merkel is not re-elected in September this year. She is being buffeted by ill domestic winds right now, yet still stands tall in the eyes of the majority of the electorate.

But who would like to predict the future five years hence? Cameron, by setting himself the deadline of 2017, has concentrated everyone's minds. Merkel has prudently not dismissed out of hand Cameron's warning about the possibility of Europe's global failure. Echoes of what Margaret Thatcher said at a symposium in Vail, Colorado, 1995: 'Political leaders are not there to accept realities. We are there to change the inevitable.'

The speech's drafters might have included Angela Merkel. Ideas like competitiveness, flexibility or democratic accountability are as much part of her political vocabulary as they are of Cameron's.



Fed comfortable with policy mix

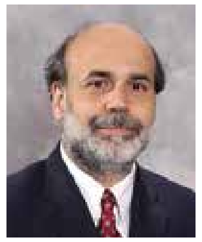
Asset purchases set to continue despite reservations

Darrell Delamaide, Board of Contributing Editors

The Federal Open Market Committee held its first meeting of 2013 just as preliminary figures indicated that the US economy contracted in the fourth quarter. The FOMC statement duly noted that 'growth in economic activity paused in recent months', but blamed the downturn on the weather (think Hurricane Sandy) and 'other transitory factors.'

Fed watchers pounced rather on new language in the statement indicating that policy makers felt they have the right mix of monetary measures. Whereas the December statement said that 'without sufficient policy accommodation, economic growth might not be strong enough,' the January statement said more confidently that the committee expects that 'with appropriate policy accommodation, economic growth will proceed at a moderate pace.'

Earlier in the month, the release of the full transcripts from the 2007 FOMC sessions showed, to no one's surprise, that panel members largely misjudged the brewing housing crisis and reacted slowly as a full-fledged credit crunch developed. Janet Yellen, then head of the San Francisco Fed and now vice chairman of the Board of Governors, and Timothy Geithner, then New York Fed chief and subsequently secretary of Treasury, were the two panel members who expressed the most concern and urged more aggressive action immediately. Perhaps not coincidentally they are mentioned most often as Bernanke's successor as chairman, though Geithner, who left the administration in January, has said he does not want the job. Nonetheless, the committee did take action, via conference calls as well as the scheduled meetings, which then as now are credited with averting an even worse crisis.

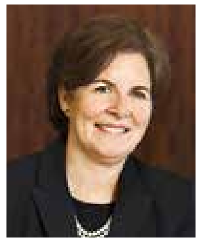


Ben Bernanke

When the host of an event at the University of Michigan last month asked Federal Reserve Chairman **Ben Bernanke (voter)** what had surprised him the most, as one of the world's experts on the Great Depression, now that he had lived through a major global crisis, he responded disarmingly with a sad smile and two words: 'The crisis.'

Regarding the current outlook, Bernanke went on to tell his Michigan audience that he is 'cautiously optimistic' about the next couple of years, even though he would prefer a faster rate of growth.

Dissent on monetary accommodation

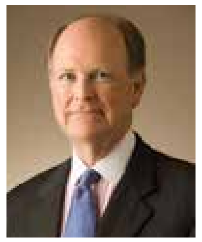


Esther George

Kansas City Fed President **Esther George**, taking part for the first time as a voting member in the January meeting, cemented her status as a hawk by taking over the role of lone dissenter from Richmond Fed chief **Jeffrey Lacker**, who rotated out as a voter. George thus brought this baton back to Kansas City, where longtime president Thomas Hoenig pioneered the role of consistently voting against the consensus statement.

The January FOMC statement noted that George voted against it because she 'was concerned that the continued high level of monetary accommodation increased the risks of future economic and financial imbalances and, over time, could cause an increase in long-term inflation expectations.'

This reservation echoed remarks she had made earlier in the month at a speech in Kansas City: 'A prolonged period of zero interest rates may substantially increase the risks of future financial imbalances and hamper attainment of the FOMC's 2% inflation goal in the future'. Her conclusion was: 'I am concerned about the high rate of unemployment, but I recognise that monetary policy, by contributing to financial imbalances and instability, can just as easily aggravate unemployment as heal it.'

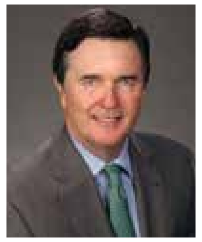


Charles Plosser

Though George may have been the only voting member to dissent, she is not the only panel member with reservations. Longtime hawk **Charles Plosser (non-voter)**, head of the Philadelphia Fed, said at a speech in Rochester, New York that he thinks the FOMC will have to tighten monetary policy more quickly than its recent statements indicate in order to keep inflation at its 2% target.

Guessing the duration of 'QE Infinity'

Since the Fed has set no end date or amount for its newest round of asset purchases, the guessing game about how long they will last will begin in earnest over the coming weeks.



Dennis Lockhart

Atlanta Fed chief **Dennis Lockhart (non-voter)** already chimed in with his prediction that the purchases will probably last most of this year at least.

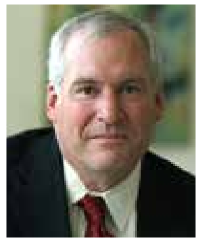
In an interview at the Bloomberg Global Markets Summit in New York, Lockhart explained that the duration of the purchases depends on the committee's qualitative assessment of improvements in the economy and the labour market.

'My own sense of this is that it's probably going to be a struggle to see by mid-year a clear indication that the outlook for the labour market is in a new phase,' he said. 'I would tend to believe this bond purchasing will need to continue longer into the year.' Whether it goes beyond that would be for the committee to decide, he said.

John Williams

In a speech a few days earlier in Atlanta, Lockhart disputed the nickname of 'QE Infinity' often used by critics for the open-ended programme. 'Open-ended' does not mean 'without bound,' he said. 'There appears to have been some confusion about this.'

San Francisco Fed President **John Williams (non-voter)** echoed Lockhart's remarks that the purchases would continue through most of 2013. 'Instead of setting an expiration date for these purchases as we have in the past, we'll be looking for convincing signs of ongoing improvement in the labour market and a range of other economic indicators before we stop this program,' he said at a conference. 'I anticipate that continued purchases of mortgage-backed securities and longer-term treasury securities will be needed well into the second half of 2013.'



Eric Rosengren

While the Fed has pegged action on interest rates to achieving an unemployment rate of 6.5%, it has not set any target for the asset purchases. Boston Fed chief **Eric Rosengren (voter)**, however, said in an interview with MarketWatch that policy makers would probably not even seriously discuss a halt to the programme until the jobless rate fell at least a half-percentage point from its December level of 7.8% (the rate for January actually rose to 7.9%).

In a speech in Providence, Rhode Island, Rosengren said that he was heartened by the effect of the Fed's policies so far. 'Overall, I see monetary policy having an impact in encouraging the purchase of interest-sensitive assets like homes, cars, and consumer durables,' he said at a local chamber of commerce forum. 'The most interest-sensitive sectors have been responding to the monetary stimulus from the Fed, and this stimulus provided a major source of strength for the economy last year. And it is likely to be a source of support in 2013.'

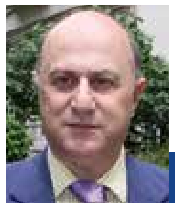
So many trillions of dollars

The asset purchases, or quantitative easing, have inflated the Fed's balance sheet to record levels, and it topped $3tn for the first time in January. With the current open-ended programme calling for purchases of $85bn a month, that figure should top $4tn by the end of the year.

One side effect is that the Fed is booking record profits, which in turns means it is remitting record amounts to the Treasury Department as required by its statutes. The Fed said it had remitted $89bn to the government for 2012, the profit it booked primarily from the interest payments on its government debt. The amounts have grown so much that Richmond's Lacker said he worried that even the slightest miscalculation by the Fed as it manages these asset purchases could trigger inflation.

'At some point, we will need to withdraw stimulus by raising interest rates and reducing the size of our balance sheet', Lacker said in Baltimore. The larger our balance sheet, the more vulnerable we will be to seemingly minor miscalibrations in policy. 'This runs the risk', he added, 'that inflation pressures emerge and are not thwarted in a timely way.'

'The most interest-sensitive sectors have been responding to the monetary stimulus from the Fed, and this stimulus provided a major source of strength for the economy last year. And it is likely to be a source of support in 2013.'



Interest rates to rise – eventually

We may see rises of 200 to 300 basis points

Gabriel Stein, Chief Economic Adviser

Ultra-low interest rates will at some stage normalise. We will then suffer a bond bear market. Investors should get ready to adjust their strategies.

Most central banks stress that current monetary policy is unusual and unconventional. As soon as possible, they say, there will be an exit strategy. In the US, the Federal Reserve has tied its exit to unemployment falling below 6.5%, which was generally interpreted to mean mid-2015. (Janet Yellen, vice chair of the Fed governors, has implied that interest rates should really remain where they are until 2016.) In fact, the Fed funds rate is likely to rise much earlier, possibly already in 2014.

There are some indications of action in the opposite direction. The ECB's governing council discussed cutting interest rates at its December meeting. It has decided not to move since then, but Mario Draghi, the ECB president, repeatedly stressed the bank's accommodative stance at his 7 February press conference, partly in reaction to the euro's recent strengthening. Euro area data remain weak and a fall in leading European interest rates may return as an issue in 2013. In Sweden and Australia, the central banks retain a bias towards easing – although, at 1% and 3% respectively, their policy interest rates are on the high side by current industrialised country standards.

On the other hand, Bank of Canada governor (and future Bank of England chief) Mark Carney, has again hinted at withdrawing some monetary stimulus. Further easing in China looks less likely if the recent uptick in inflation is a change of trend. It has been reported that fixed income hedge fund assets are overtaking equity in value for the first time ever. That is a signal that the fixed income bull market is over.

History suggests that current interest rate levels are not likely to last. The long-term average of real interest rates in major countries before (since the 1960s) and after the trans-Atlantic financial highlights the unusual nature of current circumstances (see chart on facing page).

History suggests that current interest rate levels are not likely to last. The long-term average of real interest rates in major countries before (since the 1960s) and after the trans-Atlantic financial highlights the unusual nature of current circumstances.

Before December 2007, real interest rates in major economies were on average positive and usually between 1% and 2%. Canada is a surprising exception, but this illustrates one of the dangers when looking at the very long term, namely that policy regimes can change. During the Bank of Canada's time as an inflation-targeting central bank, the real policy rate has averaged 1.3%. Japan is also an exception. But this is because from 1961 to 1989 (when the Japanese bubble burst), the long-term average real policy interest rate was deliberately kept negative to weaken the currency. One effect of Japanese deflation has been to push up the real policy interest rate even as the Bank of Japan has kept the nominal interest rate at zero.

The argument that current interest rate levels are normal must rest on the assumption that growth rates will remain permanently depressed at well below the levels of the past two decades. However, the current situation is not normal. Households are carrying excess debt. They are deleveraging. This process has gone a long way towards completion in the US, less so in other countries, but it is going on. (There are exceptions, such as Sweden and Canada, where households continue to pile up debt; but, if anything, that is an argument for tightening monetary policy to discourage the process, not the other way around).

Even if output growth rates don't return to those of the pre-crisis period, they should recover from where they are now. So interest rates should rise somewhat. Moreover, whatever current and future trend growth rates are, if real interest rates remain negative, output growth will eventually be above-trend. Sustained above-trend growth will at some stage lead to accelerating inflation. It will take longer if output gaps are massively negative. A period of above-trend growth will be necessary to close the output gap, let alone open a positive one.

If productive capacity has been destroyed in the recession, negative output gaps may not be so wide after all. Significantly, if Chinese inflation – to take but one example – is indeed accelerating again, it is doing so when the economy is growing at 7-8% at most, implying that trend growth is rather lower than that.

It is important to be clear about inflation. Broad money growth remains weak everywhere, inflation expectations are subdued, and commodity prices are easing. There is no reason to expect a sustained surge in inflation in the near future.

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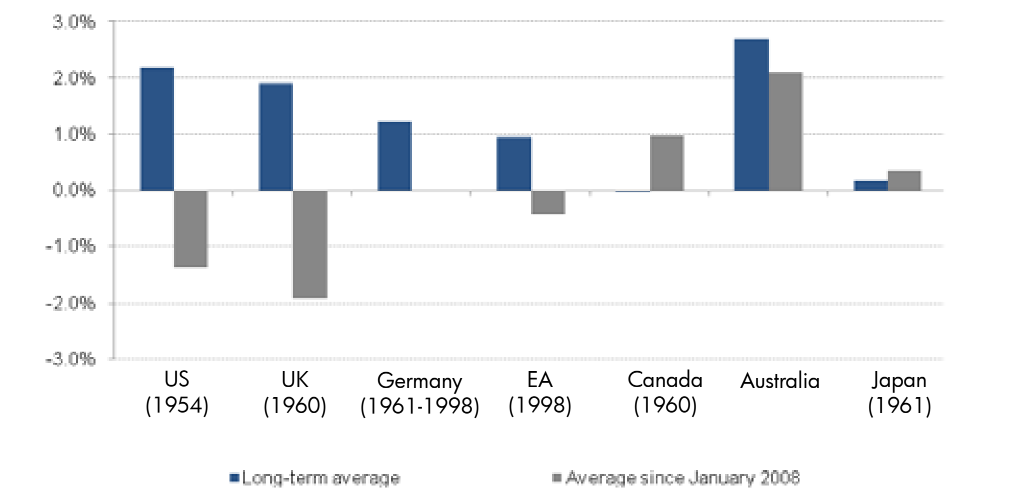
It is true that sustained above-trend growth will ultimately be inflationary – and the risk is greater if decision-makers believe that trend growth is higher than it actually is, thus attempting to stimulate growth in excess of what the economy can cope with. Yet, in spite of the talk of shifting central bank focus, it is unlikely that central bankers will be prepared to let inflation rise permanently. It would wreak havoc with their credibility for any target regime. A more likely outlook is that – once they are convinced that recovery has taken hold – central banks will be, as they already are, keen to exit their unconventional policies, not least to shrink their bloated balance sheets.

Hence, we have to assume that both nominal and real interest rates eventually will rise. The latter could come about sooner, certainly so if depressed growth in the near term pushes some countries into deflation. The timing of eventual tightening depends on economic developments in each country or region. Once deleveraging is finished, balance sheets will again be healthy. While households may not be eager to borrow again the way they did before, the drag from debt servicing will be less. Increased household consumption is likely to boost corporate spending; while a cyclical upswing will seemingly improve public finances as well, giving rise to calls for 'compensation' for groups that suffered from austerity policies. Activity could therefore rebound fairly quickly once it gains traction.

It is likely that policy interest rates eventually will revert to at least close to their long-run averages, bearing in mind that those averages include periods (notably in the 1970s) when real interest rates were negative, sometimes very much so and for a long time. If US real policy interest rates were to move near their long-term average, this would imply a rise of around 300 basis points (from -1.6% in November 2012 to +1.5%, slightly less than the long-term real average of 1.9%). Even for the euro area, the rise would be around 200bps – but here interest rates are admittedly likely to remain low for longer.

Few interest rate moves are likely in 2013, when we will see weak growth (for example in the US) or outright recession (euro area). But by 2014, at least the US economy, and perhaps others as well, should be shifting into stronger growth. Current interest rates are (or should be) supportive of both stocks and bonds. When interest rates begin to rise because economies are recovering, it will be on the back of better equity prices. But, as everyone knows, it will be bad news for fixed income.

Real policy rates (deflated by CPI, except US which is PCE deflator), long-term until December 2007 and since January 2008



ECB action buoys New Year mood

Euro area recession should end in mid-year

DZ Bank Economic Forecast Table

GDP growth	2011	2012	2013	2014
US	1.8	2.2	2.0	3.0
Japan	-0.5	1.9	1.4	1.7
China	9.3	7.8	8.5	8.7
Euro area	1.5	-0.4	-0.3	1.3
Germany	3.0	0.7	0.4	2.2
France	1.7	0.1	0.2	1.0
Italy	0.6	-2.5	-0.9	0.7
Spain	0.4	-1.4	-1.9	0.9
UK	0.9	0.0	0.4	1.4
Addendum				
Asia excl. Japan	7.4	6.1	6.9	7.3
World	3.7	3.0	3.2	3.9
Consumer prices (% y/y)				
US	3.2	2.2	2.7	3.0
Japan	3.2	2.1	2.7	3.0
China	-0.3	0.0	0.2	1.5
Euro area	5.4	2.7	3.0	4.0
Germany	2.7	2.5	2.5	2.5
France	2.5	2.1	2.1	2.6
Italy	2.3	2.2	2.3	2.4
Spain	2.9	3.3	2.4	2.4
UK	3.1	2.5	3.5	2.5
	4.5	2.8	2.3	2.7
Current account balance (% of GDP)				
US	-3.1	-3.2	-3.1	-3.2
Japan	2.0	1.0	1.2	1.7
China	2.8	2.5	2.4	2.1
Euro area	0.0	0.2	0.2	0.5
Germany	5.7	5.9	4.3	3.9
France	-2.0	-2.3	-2.2	-2.0
Italy	-3.3	-1.5	-0.8	-0.5
Spain	-3.5	-2.7	-1.6	-0.2
UK	-1.4	-3.0	-2.5	-1.8

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

Financial markets started the New Year in an extremely positive mood, almost as if the euro debt crisis was behind us. Sovereign spreads for euro countries hit by debt problems continued to shrink. Investors turned away from safe havens like German bonds.

Political assurances on the composition of the euro area, the speedy creation of the European Stability Mechanism, and above all the European Central Bank's announcement that it would, if necessary, reduce borrowing costs for troubled countries via bond purchases have all reduced uncertainty.

A number of risks remain which could re-ignite the crisis on very short notice. The troubled countries are still under close observation.

This above all concerns Italy, where the February election will determine the reform-mindedness of the future government.

Economic news has been very mixed. Growth figures for the fourth quarter turned out extremely weak, particularly for industrialised countries. Initial estimates show Germany, Spain, the US, and the UK in decline.

The euro area as a whole appears to have contracted.

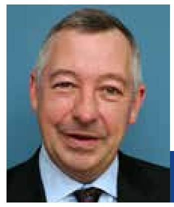
On the positive side, China already appears to have turned around, owing to renewed fiscal stimuli. The second largest economy in world should thus be in the vanguard of a global recovery.

Most recently, a number of leading indicators, mostly from Germany, surprised on the upside.

The IFO business climate index rose for the third consecutive month, pointing to an imminent acceleration of growth. Purchasing managers' indices and the ZEW index improved markedly.

On present forecasts, Germany's cyclical weakness will give way to greater strength in the next few months. And if we are spared unpleasant surprises from the euro debt crisis, the recession in monetary union should come to an end around mid-year.

Markets are hoping that this benign scenario persists into 2014.



Shell's landmark Ukraine move

Consequences for Gazprom and Putin

Nick Butler, Advisory Board

Shell's decision to invest $10bn in shale gas development in Ukraine is a significant move that will shape opportunities for investors in energy and infrastructure across Europe. It raises new questions over the value of Gazprom and associated Russian assets.

The move confirms Shell's commitment to shale and the company's determination to override environmental objections to the technology of fracking. Shell believes shale can be developed safely and cleanly enough to avoid damaging the environment or the company's reputation. This move helps confirm shale's arrival in the mainstream of the energy market. Shale gas can be considered part of a standard energy investment portfolio.

Shell clearly believes that the European gas market is going to change radically. Countries such as France and Germany may not want to develop their own shale gas but will be prepared to import either direct supplies of gas, or supplies of electricity generated by burning the gas in Ukraine and other producing countries.

The electricity market in Europe tends to be nationally based. This deal suggests that the market is now likely to change. There are big questions for those who have tied themselves into the sectors which could suffer – in particular expensive renewables.

The electricity market in Europe tends to be nationally based. This deal suggests that the market is now likely to change. Ukrainian shale reserves are likely to produce more gas than the country needs. The investment makes sense only if an export market is available. There are major medium term opportunities here for investors in infrastructure and big questions for those who have tied themselves into the sectors which could suffer – in particular expensive renewables.

Most important, the deal highlights Shell's apparent indifference to Russian opinion. Seen from Moscow, Ukraine is still in the Russian sphere of influence. Ukraine itself is divided on the matter. The eastern part tends to look to Moscow, while western Ukraine looks hopefully towards Brussels and the EU. The deal is a boost for this westward perspective.

The exploitation of shale gas in Ukraine will further undermine the market position of Gazprom. Ukraine is currently Gazprom's largest single international market. Once development gets underway – realistically five years from now – much of this trade will dry up. And once the surplus gas starts to be exported to western Europe more of Gazprom's trading business will be put in jeopardy. One can argue that this is just normal business with one technology overtaking another. On this view competition is healthy.

I am not sure if Russia in general, and its president Vladmir Putin in particular, will take such a relaxed view. Relationships between Russia and the 'near abroad' have never been good. The relationship is about more than economics, but a simple economic issue such as the changing gas market could trigger a sharp deterioration in relations.

Gazprom is a key part of the Russian state. Shell's move shifts power from Moscow to Kiev in a way that demonstrates the weakness of Russia, which while seeking to remain a superpower has not managed to escape being an economy desperately dependent on the development of natural resources. Russia is more dependent now on oil and gas revenues than it was when Putin first came to power.

Russia has already sent Ukraine a bill for $7bn for gas the country had promised to buy but did not need. It is not clear whether Ukraine, deeply in debt and seeking an IMF bail-out, can afford to pay. It's even more unclear what action Russia can take to get its money.

Cutting off supplies before any local production comes on stream would be an act of aggression and would hardly help Gazprom. In just five years shale gas in the US has come from providing minimal supplies to being the source of almost a third of daily gas needs. Worldwide resources are extensive. Their development will alter not just the energy market but also the values of many of the assets and companies involved.

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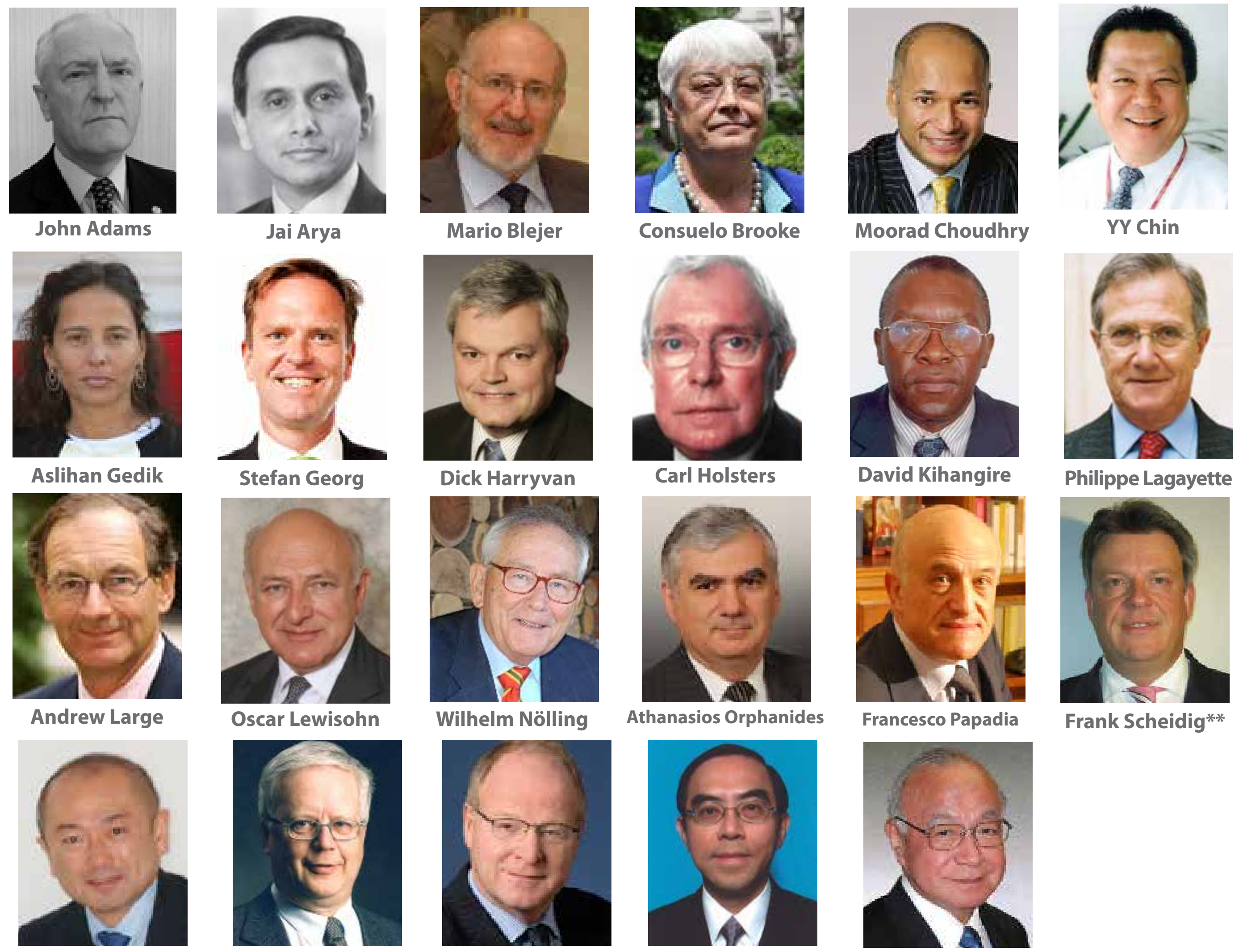

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OMFIF welcomes new members to the Advisory Board

OMFIF is pleased to welcome nine new members to the Advisory Board, taking the total number of members to 128. The OMFIF Advisory Board, covering the global economic system, includes people who contribute to OMFIF's output in many ways, who are also available to carry out advisory work and other services for OMFIF members.

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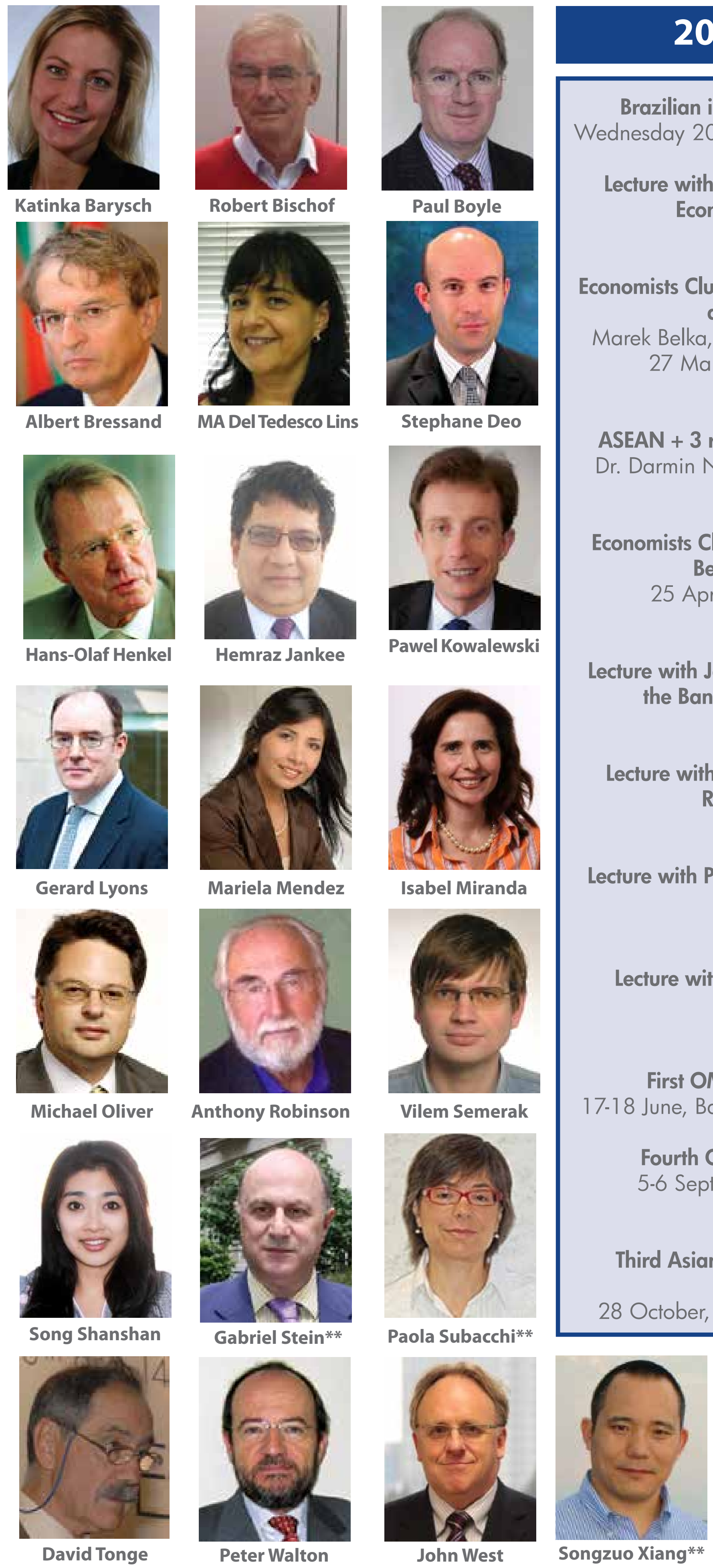


Katinka Barysch, Robert Bischof, Paul Boyle, Albert Bressand, MA Del Tedesco Lins, Stephane Deo, Hans-Olaf Henkel, Hemraz Jankee, Pawel Kowalewski, Gerard Lyons, Mariela Mendez, Isabel Miranda, Michael Oliver, Anthony Robinson, Vilem Semerak, Song Shanshan, Gabriel Stein**, Paola Subacchi**, David Tonge, Peter Walton, John West, Songzuo Xiang**

2013 diary dates

Brazilian infrastructure investment seminar
Wednesday 20 February, Embassy of Brazil, London

Lecture with Álvaro Santos Pereira, Minister of Economy and Labour, Portugal
25 February, London

Economists Club Meeting: Poland's views on Europe and the world economy
Marek Belka, President, National Bank of Poland
27 March, National Bank of Poland, Warsaw, Poland

ASEAN + 3 reserve asset management seminar
Dr. Darmin Nasution, Governor, Bank Indonesia
25 April, London

Economists Club Meeting: Economic conditions in Belgium and the euro area
25 April, National Bank of Belgium, Brussels, Belgium

Lecture with Jaime Caruana, General Manager of the Bank for International Settlements
16 May, London

Lecture with James Bullard, President, Federal Reserve Bank of St. Louis
23 May, London

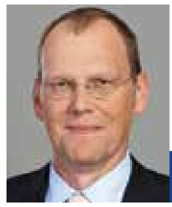
Lecture with Prof. Charlie Bean, Deputy Governor, Bank of England
29 May, London

Lecture with Prof. Stanley Fischer, Governor, Central Bank of Israel
13 June, London

First OMFIF Meeting in Latin America
17-18 June, Banco Central do Brasil Brasilia, Brazil

Fourth OMFIF Main Meeting in Europe
5-6 September, Central Bank of Turkey, Ankara, Turkey

Third Asian Central Banks' Watchers Group Annual Meeting
28 October, Bank of Korea, Seoul, South Korea



Markets in a make-believe world

Bubble crafted by central banks and governments

Stefan Bielmeier, Advisory Board

The year 2013 has on the whole started well. The euro debt crisis has almost vanished from the headlines, as has the growth dip which we are still experiencing in many major economies. The US economy has not fallen over the fiscal cliff after all, and a new stimulus package has raised spirits in Japan.

This positive sentiment has been reflected in financial markets. The German DAX, like other major share price indices, continued to perform very nicely in the first weeks of the year. Sovereign spreads for euro countries hit by debt problems continued to shrink, making it easier for them to meet their financing needs on the bond markets. Investors generally appear increasingly willing to take risks.

The primary drivers have been the major central banks. With main refinancing rates already close to zero, they backed up stimulus policies with 'unconventional' measures, often of unlimited volume and time horizon. During the acute phase of the euro debt crisis, this saved markets from collapsing. Now the effect is to push them up. Political assurances that there can be no change to the composition of the euro area helped comfort investors and reduce volatility.

The brave new world in which markets are revelling is a make-believe world. Fantasy is removed from reality. Eventually we shall see by how much.

In effect, a guarantee is being offered against market risk. One might even say that risk-taking in the markets is currently subsidised by central banks and politicians. This has led markets to run far ahead of the real economy.

Such a decoupling of financial markets is nothing new. History teaches us that it can exist for an extended period. But the current situation differs from the dotcom bubble or the various house price bubbles in one important respect. The earlier bubbles had been caused by misjudgments of the effects of technological or financial innovation on productivity and profitability, i.e. errors made by private agents. The current bubble, in contrast, has been carefully and intentionally crafted by central banks and governments.

Central bankers and politicians were well aware of the risks but saw no alternative. The idea was to 'buy time' to implement reforms of government finances and of economic structures to improve competitiveness. Yet the time needed was grossly underestimated. So we're still in the 'buying time' phase – or, as sceptics call it, 'borrowing time'.

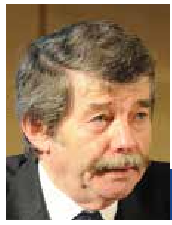
The longer this goes on, the more the initial concerns about this strategy gain credence. The positive sentiment in markets brings with it a severe risk of politicians falling back into complacency and slowing down reforms, as market pressure is perceived to have fallen. But such leniency cannot be taken for granted. Once markets become dissatisfied with a country, the mood might once again swing very quickly. Central banks would not watch on benignly if a country falls too far behind the agreed reform path. A hardening of their stance could have serious economic consequences.

Any attempt to put pressure on central banks to hold off in responding would be dangerous. This could damage central banks' independence and credibility, both of which are necessary to help monetary policy resolve the crisis.

Sooner or later the discrepancy between financial markets and the real economy will be closed. Either markets will drop to a lower level justified by the fundamentals, or the fundamentals will improve sufficiently to support market valuations. The second scenario is preferable. It is critically important to use bought, or borrowed, time to improve the fundamentals of the real economy.

The brave new world in which markets are revelling is, for now, a make-believe world. Fantasy is removed from reality. Eventually we shall see by how much.

A regular round-up on international monetary affairs



Currency wars, banking splits

New Bank of England man struts his stuff

William Keegan, Chairman, Board of Contributing Editors

Central bankers just cannot stay out of the news. One of the several disappointments of retiring Bank of England governor Sir Mervyn King is that he failed in his ambition to make monetary policy 'boring'.

Since the beginning of 2013 (by the way, there must be people out there who regard a year ending in 13 as unlucky...) we have had an outbreak of internecine warfare between leading central bankers, and publicly expressed concerns about the threats to their independence.

First came direct Japanese government intervention to constrain the independence of the Bank of Japan. This evinced a response from Jens Weidmann, president of the Bundesbank, that HSBC economist Stephen King was 'perhaps right' in forecasting the demise of central bank independence.

With the Bank of Japan being instructed to raise its inflation target and go for growth, the implications for the exchange rate led Weidmann to join the Latin American chorus about the dangers of 'currency wars'.

Then we have the guerrilla warfare between Sir Mervyn and his chosen successor – certainly not chosen by him – Mark Carney of the Bank of Canada. Carney has made no secret of his desire to abandon inflation targets in favour of targets for nominal GDP, under which in theory more emphasis would be placed on growth and less on a strict approach to inflation.

King has hit back, in a major speech in Belfast, which included a vast historical sweep about the long battle in the UK to bring inflation under control. Sir Mervyn's argument is that, after all that effort to introduce them, inflation targets should not to be abandoned. One should not forget that King himself was probably the most effective champion of inflation targets before their introduction in the UK after the Black Wednesday debacle of 1992. Nevertheless, it is worth noting that King in recent depression years has, thankfully, had an Augustinian approach to actually hitting such targets.

In effect by 'talking up' the economy and emphasising 'unconventional measures' and growth, Carney seems to be placing a hell of a lot of faith in his putative charismatic ability to boost confidence.

Carney has been strutting his stuff all over the place. Speeches in his native Canada, well-publicised appearances in Davos, and an appointment with the House of Commons Treasury Committee – in which he played down the nominal GDP proposal but called for a 'debate' on it. Carney's general reasonableness earned plaudits. But in my long career I cannot recall a Bank of England governor-designate who has been so vociferous on the way in.

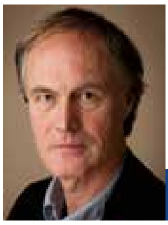
Way back in 1993 Robin Leigh-Pemberton was discreetly told by the Governor to ease up on pre-job interviews, but there appears to be no stopping Carney, who clearly loves the bigger stage. One suspects that even in the Treasury which pursued him so avidly there must be someone thinking of the famous admonition from 1945-51 Labour prime minister Clement Attlee to Labour party chairman Harold Laski: 'A period of silence on your part would be welcome.' In effect by 'talking up' the economy and emphasising 'unconventional measures' and growth, Carney seems to be placing a hell of a lot of faith in his putative charismatic ability to boost confidence.

We shall see. Despite the razzmatazz, there is nothing new about nominal growth targets. Such distinguished economists as Nobel Laureate James Meade, and long-time Financial Times commentator Sir Samuel Brittan, have championed them.

But Treasury practitioners in the 1980s found that nominal GDP was a difficult objective both to measure and to track. The economist Christopher Johnson, in his seminal work 'The Economy Under Mrs Thatcher, 1979-1990', observed how, after failing to find the Holy Grail with monetary targets, the British government found that 'the use of money GDP created further confusion and was ineffective in controlling either real growth or inflation.'

But back to currency wars: Carney will inherit partial responsibility for an economy whose real problem is not the budget deficit – which was caused largely by the financial crisis – but a chronic trade deficit, to which the financial markets are finally waking up.

Chancellor George Osborne, who went to great (even slightly comic) lengths to win Carney, has hinted at his concerns by somewhat heavy-handedly leaning on the Bank of England to do its bit for growth. My own worry is – echoes of 1976 – that the markets tend to overdo a needed adjustment. Sterling is vulnerable to just that kind of over-reaction.



Dijsselbloem's baptism of fire

SNS Reaal rescue complicates Dutch budget limit efforts

Roel Janssen, Board of Contributing Editors

Never waste a banking crisis, Jeroen Dijsselbloem must have thought. Three months in power as finance minister of the Netherlands and barely a week as the fresh chairman of the Eurogroup linking euro area finance ministers, he nationalised a major Dutch bank and insurance company.

SNS Reaal failed due to its reckless lending for real estate and property developments, both in the Netherlands and in other euro countries, particularly Spain. On 1 February it became the second Dutch bank (after ABN Amro in 2008) to enter into state control.

So Dijsselbloem's baptism of fire as Eurogroup chairman was neither rescuing Spanish banks battered by the property collapse nor dealing with Greece for failing its budget targets. He had to step in to salvage the fourth largest bank in the Netherlands.

The cost to the Dutch Treasury, €3.7bn, will add 0.6 percentage points to the budget deficit this year, increasing it to well over 3% of GDP.

It is an intriguing question whether Dijsselbloem, in his Eurogroup capacity, will demand that the Netherlands impose further cuts this year to abide with the deficit ceiling enforced by Brussels.

Jeroen Dijsselbloem, 46, an excellent salsa dancer, grows his own vegetables in the garden and speaks impeccable English. He lives in a house in the low meadows along the Rhine. When the river floods, he has to take a dinghy to reach land.

As the successor of Jean-Claude Juncker, the Luxembourg finance minister and prime minister, who chaired the Eurogroup since 2005, he will need to show aptitude in other spheres. The Eurogroup is pivotal for management of the euro crisis. Dijsselbloem is a novice on the European scene. But he's a fast learner.

Since his appointment as finance minister in November, he has spent more time with his European collegues in Brussels than with the members of the Dutch government, a coalition of social-democrats and conservatives.

He must have made a good impression. Dijsselbloem' s name quickly surfaced as Juncker's successor. This also reflected the Netherlands' status as one of the euro area's few remaining triple A countries and a monetary ally of Germany.

With Belgian Herman van Rompuy as president of the European Council, a Dutchman was the most probable candidate for the vacancy. Being a social democrat with a Catholic background may have been an additional advantage. The lack of a Dutch representative on the executive board of the European Central Bank probably clinched the deal.

In the Netherlands, Dijsselbloem was a little known politician, though he has been in politics all his life. He studied agrarian economics at Wageningen University and did a year of business economics in Ireland.

After entering parliament in 2000, he became part of a group of young social democrats, nicknamed the 'red engineers', who challenged the status quo within the party, particularly on its previous softness on immigration, educational policies and resistance to social reforms.

One of other 'red engineers' was Diederik Samson, now the leader of the social democratic party and architect of the current governement. Dijsselbloem was his right hand man in the coalition negotiations and was subsequently appointed to the finance ministry.

Compared with his predecessor, Jan Kees de Jager, Dijsselbloem is more congenial. But his calmness should not be confused with weakness. He likes to work in the background, and is known to be a tough negotiator but also to speak his mind. Contrary to assurances given by his predecessor, Dijsselbloem has made clear that Dutch taxpayers will have to pay for losses on the emergency loans extended to Greece and on the rescue of ABN Amro. With the nationalisation of SNS Reaal and the write-off of its property loans, further losses for taxpayers seem inevitable.

In Brussels, Dijsselbloem has altered the tone but not the substance of the Dutch position on the euro crisis. He remains determined to stick to budgetary consolidation. He insists that the Netherlands will adhere to the 3% deficit ceiling in 2013, though the SNS rescue will complicate this. An opponent of any increase in the European budget over 2014-21, he was a key player behind the scenes in crafting the deal reached on 8 February to peg spending at 1% of EU GDP.

His Eurogroup appointment has been gven a warm welcome in Dutch politics. 'Finally the Netherlands has returned to the heart of Europe,' said one Christian Democratic parliamentarian. Only the left-leaning socialist party and the anti-European Freedom party of Geert Wilders opposed his appointment.

According to the socialists, as chairman of the Eurogroup, Dijsselbloem will not be able to defend Dutch interests in Brussels. Wilders, who wants the Netherlands out of the European Union, somewhat predictably but slightly nonsensically demanded that Dijsselbloem immediately give up his post as finance minister.

Dijsselbloem will take all this in his stride. Having nationalised a major Dutch bank in 12 hours, he has proven his qualities as a crisis manager – even though he knows that solving the euro imbroglio will take a little longer.